

HANDBOOK OF INTERNATIONAL AUDITING, ASSURANCE, AND ETHICS PRONOUNCEMENTS

2003 EDITION

Scope of the Handbook

This Handbook brings together for continuing reference background information about the International Federation of Accountants (IFAC) and the currently effective pronouncements on Auditing, Assurance, and Ethics, issued by IFAC as of January 1, 2003.

How this Handbook is Arranged

The contents of the Handbook are arranged by Section as follows:

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CHANGES OF SUBSTANCE FROM THE 2001 EDITION OF THE HANDBOOK AND RECENT DEVELOPMENTS

References

This Handbook contains references to the International Auditing Practices Committee (IAPC) of IFAC. As of April 1, 2002, the International Auditing and Assurance Standards Board (IAASB) of IFAC replaced the IAPC.

This Handbook also contains references to the International Accounting Standards Committee (IASC). As of April 1, 2002, International Financial Reporting Standards (previously referred to as International Accounting Standards) are issued by the International Accounting Standards Board (IASB).

Additions

The following additions have been made in this edition of the Handbook:

- Section 8 of the IFAC *Code of Ethics for Professional Accountants* on “Independence for Assurance Engagements.”
- New ISA 545, “Auditing Fair Value Measurements and Disclosures.” **This Standard is effective for audits of financial statements for periods ending on or after December 31, 2003. Earlier application is permissible.**
- Revised IAPS 1004, “The Relationship Between Banking Supervisors and Banks’ External Auditors.”
- Revised IAPS 1006, “Audits of the Financial Statements of Banks.”
- New IAPS 1013, “Electronic Commerce—Effect on the Audit of Financial Statements.”

The following deletions have been made in this edition of the Handbook:

- ISA 240A, “Fraud and Error” has now been deleted. ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” is effective for audits of financial statements for periods ending on or after June 30, 2002.
- ISA 700A, “The Auditor’s Report on Financial Statements” has now been deleted. The text of ISA 700A is reflected by way of footnote in the revised ISA 700, which is effective for audits of financial statements for periods ending on or after September 30, 2002.

Recent Developments and Exposure Drafts

The following recent developments are of importance to users of the Handbook:

- ISA 100, “Assurance Engagements” is being revised to provide basic principles, essential procedures and guidance for professional accountants in public practice on the performance of assurance engagements.

- ISA 220, “Quality Control for Audit Work” is being revised to deal with quality control matters specific to engagements to audit financial statements. Firm-wide quality control matters, covering audit, assurance and related services, are to be dealt with in a new International Standard on Quality Control (ISQC), which will fall outside the body of the IAASB’s standards for audit, assurance and related services. In addition, International Professional Practice Statement (IPPS) 1, “Assuring the Quality of Professional Services” is being revised by a task force of the IFAC Board. IPPS 1 in its revised form will be renamed Statement of Membership Obligations (SMO) 1. The proposed revised ISA 220, ISQC 1 and SMO 1 (in conjunction with future standards addressing quality control matters at engagement level for assurance and related services) will establish a framework for quality control, consisting of basic principles, essential procedures and guidance directed at the level of member bodies, firms and individual engagements.
- The IAASB in October 2002 issued the following exposure drafts of proposed ISAs:
 - “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” (to replace ISA 310, “Knowledge of the Business,” ISA 400, “Risk Assessments and Internal Control” and ISA 401, “Auditing in a Computer Environment”).
 - “The Auditor’s Procedures in Response to Assessed Risks” (to replace ISA 400 and ISA 401).
 - “Audit Evidence” (to replace ISA 500, “Audit Evidence”).

In addition to the above, amendments to ISA 200, “Objective and General Principles Governing an Audit of Financial Statements” have been proposed.

The project, referred to as the Audit Risk Project, will also require conforming changes to other ISAs, which will be considered by the IAASB during 2003.

- The IAASB in October 2002 also issued an exposure draft of a proposed IAPS on “Compliance with Financial Reporting Standards,” which clarifies the auditor’s responsibilities when management comments on the extent to which financial statements comply with International Financial Reporting Standards.
- In November 2002, the IFAC Board approved the Terms of Reference of the IAASB. An exposure draft containing the proposed “Terms of Reference,” a revised “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services” and Operations Policy No. 1, “Bold Type Lettering” was issued by the IAASB in November 2002. The proposed terms of reference and preface is contained in the Auditing and Assurance Section of this Handbook.

For additional information on recent developments and to obtain outstanding exposure drafts, visit IFAC’s website at <http://www.ifac.org> or the IAASB’s website at <http://www.iaasb.org>.

INTERNATIONAL FEDERATION OF ACCOUNTANTS

Organization

The International Federation of Accountants (IFAC) is the worldwide organization for the accountancy profession. Founded in 1977, its mission is to develop and enhance the profession, with harmonized standards, to enable it to provide services of consistently high quality in the public interest. It accomplishes this mission by:

- Developing international standards on auditing and assurance services, ethics, education, and public sector accounting.
- Supporting member bodies in their efforts to serve an increasingly diverse constituency of accountants, including members in business and industry and those employed in small- and medium-sized enterprises and practices.
- Developing an international quality assurance review program for firms that audit transnational entities.
- Ensuring that its member bodies comply with membership requirements, including encouraging accountant's adherence to high quality standards.
- Working with regulators, standard setters, and financial institutions to determine how the worldwide profession can best contribute to the creation of a sound global financial architecture.

Membership

IFAC is comprised of more than 150 member bodies from every part of the globe, representing more than 2.4 million accountants in public practice, education, the public sector, industry, and commerce. No other accountancy body in the world and few other professional organizations have the broad-based international support that characterizes IFAC.

IFAC's strengths derives not only from its international representation, but also from the strength of its individual member bodies, which are themselves dedicated to promoting quality, expertise and integrity in the profession of accountancy.

Standard-Setting Initiatives

IFAC has long recognized the need for a globally harmonized framework to meet the increasingly international demands that are placed on the accountancy profession, whether from the business, education or the public sector communities. Major components of this framework are International Standards on Auditing (ISAs), the IFAC *Code of Ethics for Professional Accountants*, International Education Standards, and International Public Sector Accounting Standards (IPSASs).

Auditing and Assurance Services

The International Auditing and Assurance Standards Board (IAASB) develops ISAs and International Auditing Practice Statements (IAPs). These standards and statements serve as the benchmark for high quality auditing standards and statements worldwide.

They outline basic principles and essential procedures for auditors, giving them the tools to cope with the increased and changing demands for reports on financial information, and provide guidance in specialized areas.

In addition, IAASB develops quality control standards for firms and engagement teams in the practice areas of audit, assurance and related services.

Ethics

The IFAC *Code of Ethics for Professional Accountants*, developed by IFAC's Ethics Committee, serves as the foundation for all codes of ethics developed and enforced by member bodies. It endorses the concepts of objectivity, integrity and professional competence and is applicable to all professional accountants.

Education

Working to advance accounting education programs worldwide, IFAC's Education Committee develops International Education Standards, setting the benchmarks for the education of members of the accountancy profession. All IFAC member bodies are expected to comply with those standards, which address the education process leading to qualification as a professional accountant as well as the ongoing continuing professional development of members of the profession. The committee also develops other guidance to assist member bodies and accounting educators implement and achieve best practice in accounting education.

This Handbook does not contain the International Education Standards, which are available from the IFAC website at <http://www.ifac.org>.

Public Sector Accounting

The Public Sector Committee (PSC) is developing a comprehensive body of IPSASs. To date, the PSC has issued 20 IPSASs on the accrual basis of accounting and will soon issue a comprehensive IPSAS on the cash basis of accounting. The IPSASs represent international best practice in financial reporting by public sector entities. In many jurisdictions, the application of the requirements of IPSASs will enhance the accountability and transparency of the financial reports prepared by governments and their agencies.

The IPSASs are contained in the 2003 edition of IFAC's Handbook of International Public Sector Accounting Standards and are also available from the IFAC website at <http://www.ifac.org>.

Serving a Diverse Constituency

Both IFAC and its member bodies face the challenge of meeting the needs of an increasing number of accountants employed in business. These accountants now comprise more than 50 percent of the membership of IFAC member bodies. IFAC's Financial and Management Accounting Committee offers guidance to assist these members in addressing a wide range of professional issues and strives to build the public awareness and understanding of the work they provide.

IFAC is also focused on providing best practice guidance to another growing constituency: small- and medium-sized practices (SMPs). It is working with member bodies to determine how this can best be accomplished and how international resources can best be utilized.

Regulatory Role

IFAC has long recognized that a fundamental way to protect the public interest is to enforce a core set of internationally recognized standards as a means of ensuring the credibility of information upon which investors and other stakeholders depend. This is accomplished through an international regulatory and compliance regime. The key components are the Forum of Firms (FoF) and a Compliance Committee, with participation from outside the profession.

Firms that carry out transnational audit work are eligible for membership in the FoF. Membership obligations include compliance with ISAs and the IFAC *Code of Ethics for Professional Accountants*, and submission to periodic quality control review. The Compliance Committee monitors and encourages compliance with international standards and other measures designed to enhance the reliability of financial information and professional standards around the world.

Building Global Financial Architectures

The accounting profession is a key element in ensuring that organizations, whether in the private or public sector, operate with integrity, openness and accountability in the interests of all stakeholders and the public generally. To foster the development of an international accountancy profession characterized by the highest professional standards, IFAC continues to seek acceptance of its guidance worldwide – not only from its member bodies, but also from governments, regulators, emerging economies, developing nations, large and small firms and individual accountants. It maintains ongoing dialogue with these groups to better understand both their challenges and needs.

IFAC Structure and Operations

Governance of IFAC rests with its Board and Council. IFAC Council comprises one representative from each member body. The Board is a smaller group responsible for policy setting. IFAC is headquartered in New York City and is staffed by accounting professionals from around the world.

IFAC Website

For more information, visit IFAC's website at <http://www.ifac.org>.

ETHICS

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For additional information on the IFAC Ethics Committee, recent developments, and to obtain outstanding exposure drafts, visit the Committee's page on the IFAC website at <http://www.ifac.org/Ethics/index.tmpl>.

* Effective May 2000 the IFAC Council was renamed the IFAC Board.

IFAC ETHICS COMMITTEE—TERMS OF REFERENCE

The IFAC Ethics Committee reports to the IFAC Board. It consults with and advises the IFAC Board on all aspects of ethical issues and develops appropriate guidance on these issues for the IFAC Board's ultimate approval. It also actively promotes good ethical practices to IFAC's member bodies and to the public at large.

The Committee achieves its objectives by:

- Scheduling working sessions at appropriate locations and including seminars/consultation with the host bodies on appropriate topics;
- Organizing at its discretion, Ethics Fora to broaden discussion, attempting to coordinate such activities with other IFAC-wide activities;
- Ensuring that all proposed guidance is subject to an appropriate exposure period, as with other IFAC pronouncements; the Committee may issue such exposure drafts on its own authority, but it may, as appropriate, seek selected viewpoints prior to exposure; and
- Regularly contributing to the *IFAC News*, member body journals and other media on ethics issues.

In presenting its recommendations to the IFAC Board, the Committee explains the results of the exposure process and any other information to assist the IFAC Board in making its decisions. No exposure draft is released or proposal on the revision or issuance of guidance on ethics and related issues presented to the IFAC Board unless it is approved by at least three-fourths of the Committee members.

CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

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Definitions

In this Code of Ethics for Professional Accountants the following expressions appear in **bold type** when they are first used and have the following meanings assigned to them:

Advertising	The communication to the public of information as to the services or skills provided by professional accountants in public practice with a view to procuring professional business.
Audit client	An entity in respect of which a firm conducts an audit engagement. When the audit client is a listed entity, audit client will always include its related entities.
Audit engagement	An assurance engagement to provide a high level of assurance that financial statements are free of material misstatement, such as an engagement in accordance with International Standards on Auditing. This includes a Statutory Audit which is an audit required by national legislation or other regulation.
Assurance client	An entity in respect of which a firm conducts an assurance engagement.
Assurance engagement	<p>An engagement conducted to provide:</p> <ul style="list-style-type: none"> (a) A high level of assurance that the subject matter conforms in all material respects with identified suitable criteria; or (b) A moderate level of assurance that the subject matter is plausible in the circumstances. <p>This would include an engagement in accordance with the International Standard on Assurance Engagements issued by the International Auditing and Assurance Standards Board or in accordance with specific standards for assurance engagements issued by the International Auditing and Assurance Standards Board such as an audit or review of financial statements in accordance with International Standards on Auditing.</p>
Assurance team	<ul style="list-style-type: none"> (a) All professionals participating in the assurance engagement; (b) All others within a firm who can directly influence the outcome of the assurance engagement, including: <ul style="list-style-type: none"> • Those who recommend the compensation of, or

	<p>who provide direct supervisory, management or other oversight of the assurance engagement partner in connection with the performance of the assurance engagement. For the purposes of an audit engagement this includes those at all successively senior levels above the lead engagement partner through the firm's chief executive;</p> <ul style="list-style-type: none"> • Those who provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement; and • Those who provide quality control for the assurance engagement; and <p>(c) For the purposes of an audit client, all those within a network firm who can directly influence the outcome of the audit engagement.</p>
Client account	Any bank account which is used solely for the banking of clients' monies.
Clients' monies	Any monies – including documents of title to money <i>e.g.</i> , bills of exchange, promissory notes, and documents of title which can be converted into money <i>e.g.</i> , bearer bonds – received by a professional accountant in public practice to be held or paid out on the instruction of the person from whom or on whose behalf they are received.
Close family	A parent, non-dependent child or sibling.
Direct financial interest	<p>A financial interest:</p> <ul style="list-style-type: none"> • Owned directly by and under the control of an individual or entity (including those managed on a discretionary basis by others); or • Beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has control.
Directors and officers	Those charged with the governance of an entity, regardless of their title, which may vary from country to country.
Employed professional accountant	A professional accountant employed in industry, commerce, the public sector or education.

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Existing accountant	A professional accountant in public practice currently holding an audit appointment or carrying out accounting, taxation, consulting or similar professional services for a client.
Financial interest	An interest in an equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.
Firm	<ul style="list-style-type: none">(a) A sole practitioner, partnership or corporation of professional accountants;(b) An entity that controls such parties; and(c) An entity controlled by such parties.
Immediate family	A spouse (or equivalent) or dependent.
Independence	<p>Independence is:</p> <ul style="list-style-type: none">(a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and(b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.
Indirect financial interest	A financial interest beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has no control.
Lead engagement partner	In connection with an audit, the partner responsible for signing the report on the consolidated financial statements of the audit client, and, where relevant, the partner responsible for signing the report in respect of any entity whose financial statements form part of the consolidated financial statements and on which a separate stand-alone report is issued. When no consolidated financial statements are prepared, the lead engagement partner would be the partner responsible for signing the report on

	the financial statements.
Listed entity	An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.
Network firm	An entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.
Objectivity	A combination of impartiality, intellectual honesty and a freedom from conflicts of interest.
Office	A distinct sub-group, whether organized on geographical or practice lines.
Practice	A sole practitioner, a partnership or a corporation of professional accountants which offers professional services to the public.
Professional accountant	Those persons, whether they be in public practice, (including a sole practitioner, partnership or corporate body), industry, commerce, the public sector or education, who are members of an IFAC member body.
Professional accountant in public practice	Each partner or person occupying a position similar to that of a partner, and each employee in a practice providing professional services to a client irrespective of their functional classification (<i>e.g.</i> , audit, tax or consulting) and professional accountants in a practice having managerial responsibilities. This term is also used to refer to a firm of professional accountants in public practice.
Professional services	Any service requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services.
Publicity	The communication to the public of facts about a professional accountant which are not designed for the deliberate promotion of that professional accountant.
Receiving accountant	A professional accountant in public practice to whom the

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existing accountant or client of the existing accountant has referred audit, accounting, taxation, consulting or similar appointments, or who is consulted in order to meet the needs of the client.

Related entity

An entity that has any of the following relationships with the client:

- (a) An entity that has direct or indirect control over the client provided the client is material to such entity;
- (b) An entity with a direct financial interest in the client provided that such entity has significant influence over the client and the interest in the client is material to such entity;
- (c) An entity over which the client has direct or indirect control;
- (d) An entity in which the client, or an entity related to the client under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material to the client and its related entity in (c); and
- (e) An entity which is under common control with the client (hereinafter a “sister entity”) provided the sister entity and the client are both material to the entity that controls both the client and sister entity.

Solicitation

The approach to a potential client for the purpose of offering professional services.

Introduction

1. The International Federation of Accountants (IFAC) believes that due to national differences of culture, language, legal and social systems, the task of preparing detailed ethical requirements is primarily that of the member bodies in each country concerned and that they also have the responsibility to implement and enforce such requirements.
2. However, IFAC believes that the identity of the accountancy profession is characterized worldwide by its endeavor to achieve a number of common objectives and by its observance of certain fundamental principles for that purpose.
3. IFAC, therefore, recognizing the responsibilities of the accountancy profession as such, and considering its own role to be that of providing guidance, encouraging continuity of efforts, and promoting harmonization, has deemed it essential to establish an international Code of Ethics for Professional Accountants to be the basis on which the ethical requirements (code of ethics, detailed rules, guidelines, standards of conduct, *etc.*) for **professional accountants*** in each country should be founded.
4. This international Code is intended to serve as a model on which to base national ethical guidance. It sets standards of conduct for professional accountants and states the fundamental principles that should be observed by professional accountants in order to achieve common objectives. The accountancy profession throughout the world operates in an environment with different cultures and regulatory requirements. The basic intent of the Code, however, should always be respected. It is also acknowledged that, in those instances where a national requirement is in conflict with a provision in the Code, the national requirement would prevail. For those countries that wish to adopt the Code as their own national Code, IFAC has developed wording which may be used to indicate the authority and applicability in the country concerned. The wording is contained in the IFAC Statement of Policy of Council** *Preface to Ethical Requirements of (Name of Member Body)*.

Section 8 of this Code establishes a conceptual framework for **independence*** requirements for **assurance engagements*** that is the international standard on which national standards should be based. Accordingly, no member body or **firm*** is allowed to apply less stringent standards than those stated in that section. However, if member bodies or firms are prohibited from complying with certain parts of Section 8 by law or regulation, they should comply with all other parts of that section.

5. Further, the Code is established on the basis that unless a limitation is specifically stated, the objectives and fundamental principles are equally valid

* See Definitions.

** Effective May 2000, the IFAC Council was renamed the IFAC Board.

for all professional accountants, whether they be in public **practice**,* industry, commerce, the public sector or education.

6. A profession is distinguished by certain characteristics including:
 - Mastery of a particular intellectual skill, acquired by training and education;¹
 - Adherence by its members to a common code of values and conduct established by its administering body, including maintaining an outlook which is essentially objective; and
 - Acceptance of a duty to society as a whole (usually in return for restrictions in use of a title or in the granting of a qualification).
7. Members' duty to their profession and to society may at times seem to conflict with their immediate self interest or their duty of loyalty to their employer.
8. Against this background it is beholden on member bodies to lay down ethical requirements for their members to ensure the highest quality of performance and to maintain public confidence in the profession.

The Public Interest

9. A distinguishing mark of a profession is acceptance of its responsibility to the public. The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the **objectivity*** and integrity of professional accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on the accountancy profession. The public interest is defined as the collective well-being of the community of people and institutions the professional accountant serves.
10. A professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. The standards of the accountancy profession are heavily determined by the public interest, for example:
 - Independent auditors help to maintain the integrity and efficiency of the financial statements presented to financial institutions in partial support for loans and to stockholders for obtaining capital;
 - Financial executives serve in various financial management capacities in organizations and contribute to the efficient and effective use of the organization's resources;
 - Internal auditors provide assurance about a sound internal control system which enhances the reliability of the external financial information of the employer;

¹ For details of the education requirements recommended by IFAC, reference should be made to the International Education Guidelines prepared by the Education Committee of IFAC.

* See Definitions.

- Tax experts help to establish confidence and efficiency in, and the fair application of, the tax system; and
 - Management consultants have a responsibility toward the public interest in advocating sound management decision making.
11. Professional accountants have an important role in society. Investors, creditors, employers and other sectors of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety of business and taxation matters. The attitude and behavior of professional accountants in providing such services have an impact on the economic well-being of their community and country.
 12. Professional accountants can remain in this advantageous position only by continuing to provide the public with these unique services at a level which demonstrates that the public confidence is firmly founded. It is in the best interest of the worldwide accountancy profession to make known to users of the services provided by professional accountants that they are executed at the highest level of performance and in accordance with ethical requirements that strive to ensure such performance.
 13. In formulating their national code of ethics, member bodies should therefore consider the public service and user expectations of the ethical standards of professional accountants and take their views into account. By doing so, any existing “expectation gap” between the standards expected and those prescribed can be addressed or explained.

Objectives

14. The Code recognizes that the objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement set out above. These objectives require four basic needs to be met:
 - *Credibility*
In the whole of society there is a need for credibility in information and information systems.
 - *Professionalism*
There is a need for individuals who can be clearly identified by clients, employers and other interested parties as professional persons in the accountancy field.
 - *Quality of Services*
There is a need for assurance that all services obtained from a professional accountant are carried out to the highest standards of performance.

- *Confidence*

Users of the services of professional accountants should be able to feel confident that there exists a framework of professional ethics which governs the provision of those services.

Fundamental Principles

15. In order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles.

16. The fundamental principles are:

- *Integrity*

A professional accountant should be straightforward and honest in performing **professional services**.*

- *Objectivity*

A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

- *Professional Competence and Due Care*

A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

- *Confidentiality*

A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

- *Professional Behavior*

A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. The obligation to refrain from any conduct which might bring discredit to the profession requires IFAC member bodies to consider, when developing ethical requirements, the responsibilities of a professional accountant to clients, third parties, other members of the accountancy profession, staff, employers, and the general public.

- *Technical Standards*

A professional accountant should carry out professional services in accordance with the relevant technical and professional standards.

* See Definitions.

Professional accountants have a duty to carry out with care and skill, the instructions of the client or employer insofar as they are compatible with the requirements of integrity, objectivity and, in the case of **professional accountants in public practice**,* independence (see Section 8 below). In addition, they should conform with the technical and professional standards promulgated by:

- IFAC (*e.g.*, International Standards on Auditing);
- International Accounting Standards Board;
- The member's professional body or other regulatory body; and
- Relevant legislation.

The Code

17. The objectives as well as the fundamental principles are of a general nature and are not intended to be used to solve a professional accountant's ethical problems in a specific case. However, the Code provides some guidance as to the application in practice of the objectives and the fundamental principles with regard to a number of typical situations occurring in the accountancy profession.
18. The Code set out below is divided into three parts:
 - Part A applies to all professional accountants unless otherwise specified.
 - Part B applies only to those professional accountants in public practice.
 - Part C applies to **employed professional accountants**,* and may also apply, in appropriate circumstances, to accountants employed in public practice.

* See Definitions.

PART A — APPLICABLE TO ALL PROFESSIONAL ACCOUNTANTS

SECTION 1

Integrity and Objectivity

- 1.1 Integrity implies not merely honesty but fair dealing and truthfulness. The principle of objectivity imposes the obligation on all professional accountants to be fair, intellectually honest and free of conflicts of interest.
- 1.2 Professional accountants serve in many different capacities and should demonstrate their objectivity in varying circumstances. Professional accountants in public practice undertake assurance engagements, and render tax and other management advisory services. Other professional accountants prepare financial statements as a subordinate of others, perform internal auditing services, and serve in financial management capacities in industry, commerce, the public sector and education. They also educate and train those who aspire to admission into the profession. Regardless of service or capacity, professional accountants should protect the integrity of their professional services, and maintain objectivity in their judgment.
- 1.3 In selecting the situations and practices to be specifically dealt within ethics requirements relating to objectivity, adequate consideration should be given to the following factors:
 - (a) Professional accountants are exposed to situations which involve the possibility of pressures being exerted on them. These pressures may impair their objectivity.
 - (b) It is impracticable to define and prescribe all such situations where these possible pressures exist. Reasonableness should prevail in establishing standards for identifying relationships that are likely to, or appear to, impair a professional accountant's objectivity.
 - (c) Relationships should be avoided which allow prejudice, bias or influences of others to override objectivity.
 - (d) Professional accountants have an obligation to ensure that personnel engaged on professional services adhere to the principle of objectivity.
 - (e) Professional accountants should neither accept nor offer gifts or entertainment which might reasonably be believed to have a significant and improper influence on their professional judgment or those with whom they deal. What constitutes an excessive gift or offer of entertainment varies from country to country but professional accountants should avoid circumstances which would bring their professional standing into disrepute.

SECTION 2

Resolution of Ethical Conflicts

- 2.1 From time to time professional accountants encounter situations which give rise to conflicts of interest. Such conflicts may arise in a wide variety of ways, ranging from the relatively trivial dilemma to the extreme case of fraud and similar illegal activities. It is not possible to attempt to itemize a comprehensive check list of potential cases where conflicts of interest might occur. The professional accountant should be constantly conscious of and be alert to factors which give rise to conflicts of interest. It should be noted that an honest difference of opinion between a professional accountant and another party is not in itself an ethical issue. However, the facts and circumstances of each case need investigation by the parties concerned.
- 2.2 It is recognized, however, that there can be particular factors which occur when the responsibilities of a professional accountant may conflict with internal or external demands of one type or another. Hence:
- There may be the danger of pressure from an overbearing supervisor, manager, **director*** or partner; or when there are family or personal relationships which can give rise to the possibility of pressures being exerted upon them. Indeed, relationships or interests which could adversely influence, impair or threaten a professional accountant's integrity should be discouraged.
 - A professional accountant may be asked to act contrary to technical and/or professional standards.
 - A question of divided loyalty as between the professional accountant's superior and the required professional standards of conduct could occur.
 - Conflict could arise when misleading information is published which may be to the advantage of the employer or client and which may or may not benefit the professional accountant as a result of such publication.
- 2.3 In applying standards of ethical conduct professional accountants may encounter problems in identifying unethical behavior or in resolving an ethical conflict. When faced with significant ethical issues, professional accountants should follow the established policies of the employing organization to seek a resolution of such conflict. If those policies do not resolve the ethical conflict, the following should be considered:
- Review the conflict problem with the immediate superior. If the problem is not resolved with the immediate superior and the professional accountant determines to go to the next higher managerial level, the immediate superior should be notified of the decision. If it appears that the superior is involved in the conflict problem, the professional

* See Definitions.

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accountant should raise the issue with the next higher level of management. When the immediate superior is the Chief Executive Officer (or equivalent) the next higher reviewing level may be the Executive Committee, Board of Directors, Non-Executive Directors, Trustees, Partners' Management Committee or Shareholders.

- Seek counseling and advice on a confidential basis with an independent advisor or the applicable professional accountancy body to obtain an understanding of possible courses of action.
- If the ethical conflict still exists after fully exhausting all levels of internal review, the professional accountant as a last resort may have no other recourse on significant matters (*e.g.*, fraud) than to resign and to submit an information memorandum to an appropriate representative of that organization.

- 2.4 Furthermore, in some countries local laws, regulations or professional standards may require certain serious matters to be reported to an external body such as an enforcement or supervisory authority.
- 2.5 Any professional accountant in a senior position should endeavor to ensure that policies are established within his or her employing organization to seek resolution of conflicts.
- 2.6 Member bodies are urged to ensure that confidential counseling and advice is available to members who experience ethical conflicts.

SECTION 3

Professional Competence

- 3.1 Professional accountants should not portray themselves as having expertise or experience they do not possess.
- 3.2 Professional competence may be divided into two separate phases:
 - (a) Attainment of professional competence

The attainment of professional competence requires initially a high standard of general education followed by specific education, training and examination in professionally relevant subjects, and whether prescribed or not, a period of work experience. This should be the normal pattern of development for a professional accountant.
 - (b) Maintenance of professional competence
 - (i) The maintenance of professional competence requires a continuing awareness of developments in the accountancy profession including relevant national and international pronouncements on accounting, auditing and other relevant regulations and statutory requirements.
 - (ii) A professional accountant should adopt a program designed to ensure quality control in the performance of professional services consistent with appropriate national and international pronouncements.

SECTION 4**Confidentiality**

- 4.1 Professional accountants have an obligation to respect the confidentiality of information about a client's or employer's affairs acquired in the course of professional services. The duty of confidentiality continues even after the end of the relationship between the professional accountant and the client or employer.
- 4.2 Confidentiality should always be observed by a professional accountant unless specific authority has been given to disclose information or there is a legal or professional duty to disclose.
- 4.3 Professional accountants have an obligation to ensure that staff under their control and persons from whom advice and assistance is obtained respect the principle of confidentiality.
- 4.4 Confidentiality is not only a matter of disclosure of information. It also requires that a professional accountant acquiring information in the course of performing professional services does neither use nor appear to use that information for personal advantage or for the advantage of a third party.
- 4.5 A professional accountant has access to much confidential information about a client's or employer's affairs not otherwise disclosed to the public. Therefore, the professional accountant should be relied upon not to make unauthorized disclosures to other persons. This does not apply to disclosure of such information in order properly to discharge the professional accountant's responsibility according to the profession's standards.
- 4.6 It is in the interest of the public and the profession that the profession's standards relating to confidentiality be defined and guidance given on the nature and extent of the duty of confidentiality and the circumstances in which disclosure of information acquired during the course of providing professional services shall be permitted or required.
- 4.7 It should be recognized, however, that confidentiality of information is part of statute or common law and therefore detailed ethical requirements in respect thereof will depend on the law of the country of each member body.
- 4.8 The following are examples of the points which should be considered in determining whether confidential information may be disclosed:
 - (a) When disclosure is authorized. When authorization to disclose is given by the client or the employer the interests of all the parties including those third parties whose interests might be affected should be considered.
 - (b) When disclosure is required by law. Examples of when a professional accountant is required by law to disclose confidential information are:
 - (i) To produce documents or to give evidence in the course of legal proceedings; and

- (ii) To disclose to the appropriate public authorities infringements of the law which come to light.
- (c) When there is a professional duty or right to disclose:
 - (i) To comply with technical standards and ethics requirements; such disclosure is not contrary to this section;
 - (ii) To protect the professional interests of a professional accountant in legal proceedings;
 - (iii) To comply with the quality (or peer) review of a member body or professional body; and
 - (iv) To respond to an inquiry or investigation by a member body or regulatory body.

4.9 When the professional accountant has determined that confidential information can be disclosed, the following points should be considered:

- Whether or not all the relevant facts are known and substantiated, to the extent it is practicable to do so; when the situation involves unsubstantiated fact or opinion, professional judgment should be used in determining the type of disclosure to be made, if any;
- What type of communication is expected and the addressee; in particular, the professional accountant should be satisfied that the parties to whom the communication is addressed are appropriate recipients and have the responsibility to act on it; and
- Whether or not the professional accountant would incur any legal liability having made a communication and the consequences thereof.

In all such situations, the professional accountants should consider the need to consult legal counsel and/or the professional organization(s) concerned.

SECTION 5**Tax Practice**

- 5.1 A professional accountant rendering professional tax services is entitled to put forward the best position in favor of a client, or an employer, provided the service is rendered with professional competence, does not in any way impair integrity and objectivity, and is in the opinion of the professional accountant consistent with the law. Doubt may be resolved in favor of the client or the employer if there is reasonable support for the position.
- 5.2 A professional accountant should not hold out to a client or an employer the assurance that the tax return prepared and the tax advice offered are beyond challenge. Instead, the professional accountant should ensure that the client or the employer are aware of the limitations attaching to tax advice and services so that they do not misinterpret an expression of opinion as an assertion of fact.
- 5.3 A professional accountant who undertakes or assists in the preparation of a tax return should advise the client or the employer that the responsibility for the content of the return rests primarily with the client or employer. The professional accountant should take the necessary steps to ensure that the tax return is properly prepared on the basis of the information received.
- 5.4 Tax advice or opinions of material consequence given to a client or an employer should be recorded, either in the form of a letter or in a memorandum for the files.
- 5.5 A professional accountant should not be associated with any return or communication in which there is reason to believe that it:
 - (a) Contains a false or misleading statement;
 - (b) Contains statements or information furnished recklessly or without any real knowledge of whether they are true or false; or
 - (c) Omits or obscures information required to be submitted and such omission or obscurity would mislead the revenue authorities.
- 5.6 A professional accountant may prepare tax returns involving the use of estimates if such use is generally acceptable or if it is impractical under the circumstances to obtain exact data. When estimates are used, they should be presented as such in a manner so as to avoid the implication of greater accuracy than exists. The professional accountant should be satisfied that estimated amounts are reasonable under the circumstances.
- 5.7 In preparing a tax return, a professional accountant ordinarily may rely on information furnished by the client or employer provided that the information appears reasonable. Although the examination or review of documents or other evidence in support of the information is not required, the professional

accountant should encourage, when appropriate, such supporting data to be provided.

In addition, the professional accountant:

- (a) Should make use of the client's returns for prior years whenever feasible;
- (b) Is required to make reasonable inquiries when the information presented appears to be incorrect or incomplete; and
- (c) Is encouraged to make reference to the books and records of the business operations.

5.8 When a professional accountant learns of a material error or omission in a tax return of a prior year (with which the professional accountant may or may not have been associated), or of the failure to file a required tax return, the professional accountant has a responsibility to:

- (a) Promptly advise the client or employer of the error or omission and recommend that disclosure be made to the revenue authorities. Normally, the professional accountant is not obligated to inform the revenue authorities, nor may this be done without permission.
- (b) If the client or the employer does not correct the error the professional accountant:
 - (i) Should inform the client or the employer that it is not possible to act for them in connection with that return or other related information submitted to the authorities; and
 - (ii) Should consider whether continued association with the client or employer in any capacity is consistent with professional responsibilities.
- (c) If the professional accountant concludes that a professional relationship with the client or employer can be continued, all reasonable steps should be taken to ensure that the error is not repeated in subsequent tax returns.
- (d) Professional or statutory requirements in some countries may also make it necessary for the professional accountant to inform the revenue authorities that there is no longer any association with the return or other information involved and that acting for the client or employer has ceased. In these circumstances, the professional accountant should advise the client or employer of the position before informing the authorities and should give no further information to the authorities without the consent of the client or employer unless required to do so by law.

SECTION 6**Cross Border Activities**

- 6.1 When considering the application of ethical requirements in cross border activities a number of situations may arise. Whether a professional accountant is a member of the profession in one country only or is also a member of the profession in the country where the services are performed should not affect the manner of dealing with each situation.
- 6.2 A professional accountant qualifying in one country may reside in another country or may be temporarily visiting that country to perform professional services. In all circumstances, the professional accountant should carry out professional services in accordance with the relevant technical standards and ethical requirements. The particular technical standards which should be followed are not dealt within this section. In all other respects, however, the professional accountant should be guided by the ethical requirements set out below.
- 6.3 When a professional accountant performs services in a country other than the home country and differences on specific matters exist between ethical requirements of the two countries the following provisions should be applied:
- (a) When the ethical requirements of the country in which the services are being performed are less strict than the IFAC Code of Ethics, then the IFAC Code of Ethics should be applied.
 - (b) When the ethical requirements of the country in which services are being performed are stricter than the IFAC Code of Ethics, then the ethical requirements in the country where services are being performed should be applied.
 - (c) When the ethical requirements of the home country are mandatory for services performed outside that country and are stricter than set out in (a) and (b) above, then the ethical requirements of the home country should be applied. (In the case of cross border advertising and solicitation see also section 14 paragraph 14.4 and 14.5 below.)

PART B — APPLICABLE TO PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE

SECTION 8

Independence

8.1 It is in the public interest and, therefore, required by this Code of Ethics, that members of **assurance teams**,* firms and, when applicable, **network firms*** be independent of **assurance clients**.*

8.2 Assurance engagements are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria. The International Standard on Assurance Engagements issued by the International Auditing and Assurance Standards Board describes the objectives and elements of assurance engagements to provide either a high or a moderate level of assurance. The International Auditing and Assurance Standards Board has also issued specific standards for certain assurance engagements. For example, International Standards on Auditing provide specific standards for audit (high level assurance) and review (moderate level assurance) of financial statements.

Paragraphs 8.3 through 8.6 are taken from the International Standard on Assurance Engagements and describe the nature of an assurance engagement. These paragraphs are presented here only to describe the nature of an assurance engagement. To obtain a full understanding of the objectives and elements of an assurance engagement it is necessary to refer to the full text contained in the International Standards on Assurance Engagements.

8.3 Whether a particular engagement is an assurance engagement will depend upon whether it exhibits all the following elements:

(a) A three party relationship involving:

(i) A professional accountant;

(ii) A responsible party; and

(iii) An intended user;

(b) A subject matter;

(c) Suitable criteria;

(d) An engagement process; and

(e) A conclusion.

The responsible party and the intended user will often be from separate organizations but need not be. A responsible party and an intended user may both be within the same organization. For example, a governing body may

* See Definitions.

seek assurance about information provided by a component of that organization. The relationship between the responsible party and the intended user needs to be viewed within the context of a specific engagement.

- 8.4 There is a broad range of engagements to provide a high or moderate level of assurance. Such engagements may include:
- Engagements to report on a broad range of subject matters covering financial and non-financial information;
 - Attest and direct reporting engagements;
 - Engagements to report internally and externally; and
 - Engagements in the private and public sector.
- 8.5 The subject matter of an assurance engagement may take many forms, such as the following:
- Data (for example, historical or prospective financial information, statistical information, performance indicators);
 - Systems and processes (for example, internal controls); or
 - Behavior (for example, corporate governance, compliance with regulation, human resource practices).
- 8.6 Not all engagements performed by professional accountants are assurance engagements. Other engagements frequently performed by professional accountants that are not assurance engagements include:
- Agreed-upon procedures;
 - Compilation of financial or other information;
 - Preparation of tax returns when no conclusion is expressed, and tax consulting;
 - Management consulting; and
 - Other advisory services.
- 8.7 This section of the Code of Ethics (this section) provides a framework, built on principles, for identifying, evaluating and responding to threats to independence. The framework establishes principles that members of assurance teams, firms and network firms should use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. Judgment is needed to determine which safeguards are to be applied. Some safeguards may eliminate the threat while others may reduce the threat to an acceptable level. This section requires members of assurance teams, firms and network firms to apply the principles to the particular circumstances under consideration. The examples presented are intended to illustrate the application of the principles in this section and are

not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances that may create threats to independence. Consequently, it is not sufficient for a member of an assurance team, a firm or a network firm merely to comply with the examples presented, rather they should apply the principles in this section to the particular circumstances they face.

A Conceptual Approach to Independence

8.8 Independence requires:

(a) Independence of mind:

The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

(b) Independence in appearance:

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

8.9 The use of the word “independence” on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

8.10 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest.

8.11 This section is based on such a conceptual approach, one that takes into account threats to independence, accepted safeguards and the public interest. Under this approach, firms and members of assurance teams have an obligation to identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate these threats or to reduce them to an acceptable level by the application of safeguards. In addition to identifying and evaluating relationships between the firm, network firms, members of the assurance team and the assurance client,

consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client create threats to independence.

- 8.12 This section provides a framework of principles that members of assurance teams, firms and network firms should use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level, such that independence of mind and independence in appearance are not compromised.
- 8.13 The principles in this section apply to all assurance engagements. The nature of the threats to independence and the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level differ depending on the characteristics of the individual engagement: whether the assurance engagement is an **audit engagement*** or another type of engagement; and in the case of an assurance engagement that is not an audit engagement, the purpose, subject matter and intended users of the report. A firm should, therefore, evaluate the relevant circumstances, the nature of the assurance engagement and the threats to independence in deciding whether it is appropriate to accept or continue an engagement, as well as the nature of the safeguards required and whether a particular individual should be a member of the assurance team.
- 8.14 Audit engagements provide assurance to a wide range of potential users; consequently, in addition to independence of mind, independence in appearance is of particular significance. Accordingly, for audit clients*, the members of the assurance team, the firm and network firms are required to be independent of the audit client. Similar considerations in the case of assurance engagements provided to non-audit assurance clients require the members of the assurance team and the firm to be independent of the non-audit assurance client. In the case of these engagements, consideration should be given to any threats that the firm has reason to believe may be created by network firm interests and relationships.
- 8.15 In the case of an assurance report to a non-audit assurance client expressly restricted for use by identified users, the users of the report are considered to be knowledgeable as to the purpose, subject matter and limitations of the report through their participation in establishing the nature and scope of the firm's instructions to deliver the services, including the criteria by which the subject matter are to be evaluated. This knowledge and enhanced ability of the firm to communicate about safeguards with all users of the report increase the effectiveness of safeguards to independence in appearance. These circumstances may be taken into account by the firm in evaluating the threats to independence and considering the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level. At a minimum, it

* See Definitions.

will be necessary to apply the provisions of this section in evaluating the independence of members of the assurance team and their immediate and close family*. Further, if the firm had a material financial interest*, whether direct or indirect, in the assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Limited consideration of any threats created by network firm interests and relationships may be sufficient.

8.16 Accordingly:

- For assurance engagements provided to an audit client, the members of the assurance team, the firm and network firms are required to be independent of the client;
- For assurance engagements provided to clients that are not audit clients, when the report is not expressly restricted for use by identified users, the members of the assurance team and the firm are required to be independent of the client; and
- For assurance engagements provided to clients that are not audit clients, when the assurance report is expressly restricted for use by identified users, the members of the assurance team are required to be independent of the client. In addition, the firm should not have a material **direct** or **indirect financial interest*** in the client.

These independence requirements for assurance engagements are illustrated as follows:

Client	Type of Assurance Engagement		
	Audit	Non-audit – not restricted use	Non-audit – restricted use
Audit client	Assurance team, firm and network firms		
Non-audit assurance client		Assurance team and firm	Assurance team and firm has no material financial interest

- 8.17 The threats and safeguards identified in this section are generally discussed in the context of interests or relationships between the firm, network firms, a member of the assurance team and the assurance client. In the case of a listed audit client, the firm and any network firms are required to consider the interests and relationships that involve that client's related entities. Ideally those entities and the interests and relationships should be identified in advance. For all other assurance clients, when the assurance team has reason to believe that a **related entity*** of such an assurance client is relevant to the evaluation of the firm's independence of the client, the assurance team should

* See Definitions.

consider that related entity when evaluating independence and applying appropriate safeguards.

- 8.18 The evaluation of threats to independence and subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a firm, a network firm or a member of the assurance team knows, or could reasonably be expected to know, of circumstances or relationships that might compromise independence. There may be occasions when the firm, a network firm or an individual inadvertently violates this section. If such an inadvertent violation occurs, it would generally not compromise independence with respect to an assurance client provided the firm has appropriate quality control policies and procedures in place to promote independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied.
- 8.19 Throughout this section, reference is made to significant and clearly insignificant threats in the evaluation of independence. In considering the significance of any particular matter, qualitative as well as quantitative factors should be taken into account. A matter should be considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

Objective and Structure of this Section

- 8.20 The objective of this section is to assist firms and members of assurance teams in:

- (a) Identifying threats to independence;
- (b) Evaluating whether these threats are clearly insignificant; and
- (c) In cases when the threats are not clearly insignificant, identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level.

In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.

- 8.21 This section outlines the threats to independence (paragraphs 8.28 through 8.33). It then analyzes safeguards capable of eliminating these threats or reducing them to an acceptable level (paragraphs 8.34 through 8.47). It concludes with some examples of how this conceptual approach to independence is to be applied to specific circumstances and relationships. The examples discuss threats to independence that may be created by specific circumstances and relationships (paragraphs 8.100 onwards). Professional judgment is used to determine the appropriate safeguards to eliminate threats to independence or to reduce them to an acceptable level. In certain examples, the threats to independence are so significant the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or

continue the assurance engagement. In other examples, the threat can be eliminated or reduced to an acceptable level by the application of safeguards. The examples are not intended to be all-inclusive.

- 8.22 When threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the assurance engagement, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.
- 8.23 The evaluation of the significance of any threats to independence and the safeguards necessary to reduce any threats to an acceptable level, takes into account the public interest. Certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Examples of such entities might include listed companies, credit institutions, insurance companies, and pension funds. Because of the strong public interest in the financial statements of listed entities, certain paragraphs in this section deal with additional matters that are relevant to the audit of listed entities. Consideration should be given to the application of the principles set out in this section in relation to the audit of listed entities to other audit clients that may be of significant public interest.

National Perspectives

- 8.24 This section establishes a conceptual framework for independence requirements for assurance engagements that is the international standard on which national standards should be based. Accordingly, no member body or firm is allowed to apply less stringent standards than those stated in this section. When, however, member bodies or firms are prohibited from complying with certain parts of this section by law or regulation they should comply with all other parts of this section.
- 8.25 Certain examples in this section indicate how the principles are to be applied to **listed entity*** audit engagements. When a member body chooses not to differentiate between listed entity audit engagements and other audit engagements, the examples that relate to listed entity audit engagements should be considered to apply to all audit engagements.
- 8.26 When a firm conducts an assurance engagement in accordance with the International Standard on Assurance Engagements or with specific standards for assurance engagements issued by the International Auditing and Assurance Standards Board such as an audit or review of financial statements in accordance with International Standards on Auditing, the members of the assurance team and the firm should comply with this section unless they are prohibited from complying with certain parts of this section by law or regulation. In such cases, the members of the assurance team and the firm should comply with all other parts of this section.

* See Definitions.

- 8.27 Some countries and cultures may have set out, either by legislation or common practice, different definitions of relationships from those used in this section. For example, some national legislators or regulators may have prescribed lists of individuals who should be regarded as close family that differ from the definition contained in this section. Firms, network firms and members of assurance teams should be aware of those differences and comply with the more stringent requirements.

Threats to Independence

- 8.28 Independence is potentially affected by self-interest, self-review, advocacy, familiarity and intimidation threats.

- 8.29 “Self-Interest Threat” occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) A direct financial interest or material indirect financial interest in an assurance client;
- (b) A loan or guarantee to or from an assurance client or any of its **directors or officers**;^{*}
- (c) Undue dependence on total fees from an assurance client;
- (d) Concern about the possibility of losing the engagement;
- (e) Having a close business relationship with an assurance client;
- (f) Potential employment with an assurance client; and
- (g) Contingent fees relating to assurance engagements.

- 8.30 “Self-Review Threat” occurs when (1) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement or (2) when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) A member of the assurance team being, or having recently been, a director or officer of the assurance client;
- (b) A member of the assurance team being, or having recently been, an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement;

^{*} See Definitions.

- (c) Performing services for an assurance client that directly affect the subject matter of the assurance engagement; and
- (d) Preparation of original data used to generate financial statements or preparation of other records that are the subject matter of the assurance engagement.

- 8.31 “Advocacy Threat” occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client’s position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgment to that of the client.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) Dealing in, or being a promoter of, shares or other securities in an assurance client; and
- (b) Acting as an advocate on behalf of an assurance client in litigation or in resolving disputes with third parties.

- 8.32 “Familiarity Threat” occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client’s interests.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) A member of the assurance team having an **immediate family*** member or close family member who is a director or officer of the assurance client;
- (b) A member of the assurance team having an immediate family member or close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- (c) A former partner of the firm being a director, officer of the assurance client or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- (d) Long association of a senior member of the assurance team with the assurance client; and
- (e) Acceptance of gifts or hospitality, unless the value is clearly insignificant, from the assurance client, its directors, officers or employees.

- 8.33 “Intimidation Threat” occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by

* See Definitions.

threats, actual or perceived, from the directors, officers or employees of an assurance client.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) Threat of replacement over a disagreement with the application of an accounting principle; and
- (b) Pressure to reduce inappropriately the extent of work performed in order to reduce fees.

Safeguards

8.34 The firm and members of the assurance team have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats or reduce them to an acceptable level.

8.35 When threats are identified, other than those that are clearly insignificant, appropriate safeguards should be identified and applied to eliminate the threats or reduce them to an acceptable level. This decision should be documented. The nature of the safeguards to be applied will vary depending upon the circumstances. Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable. The consideration will be affected by matters such as the significance of the threat, the nature of the assurance engagement, the intended users of the assurance report and the structure of the firm.

8.36 Safeguards fall into three broad categories:

- (a) Safeguards created by the profession, legislation or regulation;
- (b) Safeguards within the assurance client; and
- (c) Safeguards within the firm's own systems and procedures.

The firm and the members of the assurance team should select appropriate safeguards to eliminate or reduce threats to independence, other than those that are clearly insignificant, to an acceptable level.

8.37 Safeguards created by the profession, legislation or regulation, include the following:

- (a) Educational, training and experience requirements for entry into the profession;
- (b) Continuing education requirements;
- (c) Professional standards and monitoring and disciplinary processes;
- (d) External review of a firm's quality control system; and
- (e) Legislation governing the independence requirements of the firm.

- 8.38 Safeguards within the assurance client, include the following:
- (a) When the assurance client's management appoints the firm, persons other than management ratify or approve the appointment;
 - (b) The assurance client has competent employees to make managerial decisions;
 - (c) Policies and procedures that emphasize the assurance client's commitment to fair financial reporting;
 - (d) Internal procedures that ensure objective choices in commissioning non-assurance engagements; and
 - (e) A corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm's services.
- 8.39 Audit committees can have an important corporate governance role when they are independent of client management and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There should be regular communications between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities regarding relationships and other matters that might, in the firm's opinion, reasonably be thought to bear on independence.
- 8.40 Firms should establish policies and procedures relating to independence communications with audit committees, or others charged with governance. In the case of the audit of listed entities, the firm should communicate orally and in writing at least annually, all relationships and other matters between the firm, network firms and the audit client that in the firm's professional judgment may reasonably be thought to bear on independence. Matters to be communicated will vary in each circumstance and should be decided by the firm, but should generally address the relevant matters set out in this section.
- 8.41 Safeguards within the firm's own systems and procedures may include firm-wide safeguards such as the following:
- (a) Firm leadership that stresses the importance of independence and the expectation that members of assurance teams will act in the public interest;
 - (b) Policies and procedures to implement and monitor quality control of assurance engagements;
 - (c) Documented independence policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the identification and application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level;

- (d) Internal policies and procedures to monitor compliance with firm policies and procedures as they relate to independence;
 - (e) Policies and procedures that will enable the identification of interests or relationships between the firm or members of the assurance team and assurance clients;
 - (f) Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single assurance client;
 - (g) Using different partners and teams with separate reporting lines for the provision of non-assurance services to an assurance client;
 - (h) Policies and procedures to prohibit individuals who are not members of the assurance team from influencing the outcome of the assurance engagement;
 - (i) Timely communication of a firm's policies and procedures, and any changes thereto, to all partners and professional staff, including appropriate training and education thereon;
 - (j) Designating a member of senior management as responsible for overseeing the adequate functioning of the safeguarding system;
 - (k) Means of advising partners and professional staff of those assurance clients and related entities from which they must be independent;
 - (l) A disciplinary mechanism to promote compliance with policies and procedures; and
 - (m) Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them; this includes informing staff of the procedures open to them.
- 8.42 Safeguards within the firm's own systems and procedures may include engagement specific safeguards such as the following:
- (a) Involving an additional professional accountant to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or network firm, or someone within the firm or network firm who was not otherwise associated with the assurance team;
 - (b) Consulting a third party, such as a committee of independent directors, a professional regulatory body or another professional accountant;
 - (c) Rotation of senior personnel;
 - (d) Discussing independence issues with the audit committee or others charged with governance;
 - (e) Disclosing to the audit committee, or others charged with governance, the nature of services provided and extent of fees charged;

- (f) Policies and procedures to ensure members of the assurance team do not make, or assume responsibility for, management decisions for the assurance client;
 - (g) Involving another firm to perform or re-perform part of the assurance engagement;
 - (h) Involving another firm to re-perform the non-assurance service to the extent necessary to enable it to take responsibility for that service; and
 - (i) Removing an individual from the assurance team, when that individual's financial interests or relationships create a threat to independence.
- 8.43 When the safeguards available, such as those described above, are insufficient to eliminate the threats to independence or to reduce them to an acceptable level, or when a firm chooses not to eliminate the activities or interests creating the threat, the only course of action available will be the refusal to perform, or withdrawal from, the assurance engagement.

Engagement Period

- 8.44 The members of the assurance team and the firm should be independent of the assurance client during the period of the assurance engagement. The period of the engagement starts when the assurance team begins to perform assurance services and ends when the assurance report is issued, except when the assurance engagement is of a recurring nature. If the assurance engagement is expected to recur, the period of the assurance engagement ends with the notification by either party that the professional relationship has terminated or the issuance of the final assurance report, whichever is later.
- 8.45 In the case of an audit engagement, the engagement period includes the period covered by the financial statements reported on by the firm. When an entity becomes an audit client during or after the period covered by the financial statements that the firm will report on, the firm should consider whether any threats to independence may be created by:
- Financial or business relationships with the audit client during or after the period covered by the financial statements, but prior to the acceptance of the audit engagement; or
 - Previous services provided to the audit client.

Similarly, in the case of an assurance engagement that is not an audit engagement, the firm should consider whether any financial or business relationships or previous services may create threats to independence.

- 8.46 If non-assurance services were provided to the audit client during or after the period covered by the financial statements but before the commencement of professional services in connection with the audit and those services would be prohibited during the period of the audit engagement, consideration should be given to the threats to independence, if any, arising from those services. If the threat is other than clearly insignificant, safeguards should be considered and

applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing independence issues related to the provision of the non-assurance services with those charged with governance of the client, such as the audit committee;
- Obtaining the audit client's acknowledgement of responsibility for the results of the non-assurance services;
- Precluding personnel who provided the non-assurance services from participating in the audit engagement; and
- Engaging another firm to review the results of the non-assurance services or having another firm re-perform the non-assurance services to the extent necessary to enable it to take responsibility for those services.

8.47 Non-assurance services provided to a non-listed audit client will not impair the firm's independence when the client becomes a listed entity provided:

- The previous non-assurance services were permissible under this section for non-listed audit clients;
- The services will be terminated within a reasonable period of time of the client becoming a listed entity, if they are impermissible under this section for listed audit clients; and
- The firm has implemented appropriate safeguards to eliminate any threats to independence arising from the previous services or reduce them to an acceptable level.

Effective Date

8.48 This section is applicable to assurance engagements when the assurance report is dated on or after December 31, 2004. Earlier application is encouraged.

Application of Principles to Specific Situations

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Introduction

- 8.100 The following examples describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and the safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level in each circumstance. The examples are not all-inclusive. In practice, the firm, network firms and the members of the assurance team will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards, including the safeguards in paragraphs 8.37 through 8.42 can be applied to satisfactorily address the threats to independence. Paragraphs 8.1 through 8.48 of this section provide conceptual guidance to assist in this process.
- 8.101 Some of the examples deal with audit clients while others deal with assurance clients that are not audit clients. The examples illustrate how safeguards should be applied to fulfill the requirement for the members of the assurance team, the firm and network firms to be independent of an audit client, and for the members of the assurance team and the firm to be independent of an assurance client that is not an audit client. The examples do not include assurance reports to a non-audit assurance client expressly restricted for use by identified users. As stated in paragraph 8.15 for such engagements, members of the assurance team and their immediate and close family are required to be independent of the assurance client. Further, the firm should not have a material financial interest, direct or indirect, in the assurance client.

Financial Interests

- 8.102 A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).
- 8.103 When evaluating the type of financial interest, consideration should be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or the financial interest held (*e.g.*, a mutual fund, unit trust or similar intermediary vehicle) to those where the individual has control over the financial interest (*e.g.*, as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to independence, it is important to consider the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy. When control exists, the financial interest should be considered direct. Conversely, when the holder of the financial interest has no ability to exercise such control the financial interest should be considered indirect.

Provisions Applicable to all Assurance Clients

8.104 If a member of the assurance team, or their immediate family member, has a direct financial interest, or a material indirect financial interest, in the assurance client, the self-interest threat created would be so significant the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:

- Dispose of the direct financial interest prior to the individual becoming a member of the assurance team;
- Dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the assurance team; or
- Remove the member of the assurance team from the assurance engagement.

8.105 If a member of the assurance team, or their immediate family member receives, by way of, for example, an inheritance, gift or, as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards should be applied to eliminate the threat or reduce it to an acceptable level:

- Disposing of the financial interest at the earliest practical date; or
- Removing the member of the assurance team from the assurance engagement.

During the period prior to disposal of the financial interest or the removal of the individual from the assurance team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant to review the work done, or otherwise advise as necessary.

8.106 When a member of the assurance team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. In evaluating the significance of any threat, consideration should be given to the nature of the relationship between the member of the assurance team and the close family member and the materiality of the financial interest. Once the significance of the threat has been evaluated, safeguards should be considered and applied as necessary. Such safeguards might include:

- The close family member disposing of all or a sufficient portion of the financial interest at the earliest practical date;

- Discussing the matter with those charged with governance, such as the audit committee;
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team with the close family relationship or otherwise advise as necessary; or
- Removing the individual from the assurance engagement.

8.107 When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest should only be held when:

- The member of the assurance team, an immediate family member of the member of the assurance team, and the firm are not beneficiaries of the trust;
- The interest held by the trust in the assurance client is not material to the trust;
- The trust is not able to exercise significant influence over the assurance client; and
- The member of the assurance team or the firm does not have significant influence over any investment decision involving a financial interest in the assurance client.

8.108 Consideration should be given to whether a self-interest threat may be created by the financial interests of individuals outside of the assurance team and their immediate and close family members. Such individuals would include:

- Partners, and their immediate family members, who are not members of the assurance team;
- Partners and managerial employees who provide non-assurance services to the assurance client; and
- Individuals who have a close personal relationship with a member of the assurance team.

Whether the interests held by such individuals may create a self-interest threat will depend upon factors such as:

- The firm's organizational, operating and reporting structure; and
- The nature of the relationship between the individual and the member of the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as

necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Where appropriate, policies to restrict people from holding such interests;
- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done or otherwise advise as necessary.

8.109 An inadvertent violation of this section as it relates to a financial interest in an assurance client would not impair the independence of the firm, the network firm or a member of the assurance team when:

- (a) The firm, and the network firm, has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client;
- (b) The firm, and the network firm, promptly notifies the professional that the financial interest should be disposed of; and
- (c) The disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.

8.110 When an inadvertent violation of this section relating to a financial interest in an assurance client has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Provisions Applicable to Audit Clients

8.111 If a firm, or a network firm, has a direct financial interest in an audit client of the firm the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

8.112 If a firm, or a network firm, has a material indirect financial interest in an audit client of the firm a self-interest threat is also created. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

- 8.113 If a firm, or a network firm, has a material financial interest in an entity that has a controlling interest in an audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
- 8.114 If the retirement benefit plan of a firm, or network firm, has a financial interest in an audit client a self-interest threat may be created. Accordingly, the significance of any such threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.
- 8.115 If other partners, including partners who do not perform assurance engagements, or their immediate family, in the **office*** in which the **lead engagement partner*** practices in connection with the audit hold a direct financial interest or a material indirect financial interest in that audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such partners or their immediate family should not hold any such financial interests in such an audit client.
- 8.116 The office in which the lead engagement partner practices in connection with the audit is not necessarily the office to which that partner is assigned. Accordingly, when the lead engagement partner is located in a different office from that of the other members of the assurance team, judgment should be used to determine in which office the partner practices in connection with that audit.
- 8.117 If other partners and managerial employees who provide non-assurance services to the audit client, except those whose involvement is clearly insignificant, or their immediate family, hold a direct financial interest or a material indirect financial interest in the audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such personnel or their immediate family should not hold any such financial interests in such an audit client.
- 8.118 A financial interest in an audit client that is held by an immediate family member of (a) a partner located in the office in which the lead engagement partner practices in connection with the audit, or (b) a partner or managerial employee who provides non-assurance services to the audit client is not considered to create an unacceptable threat provided it is received as a result of their employment rights (*e.g.*, pension rights or share options) and, where necessary, appropriate safeguards are applied to reduce any threat to independence to an acceptable level.

* See Definitions.

- 8.119 A self-interest threat may be created if the firm, or the network firm, or a member of the assurance team has an interest in an entity and an audit client, or a director, officer or controlling owner thereof also has an investment in that entity. Independence is not compromised with respect to the audit client if the respective interests of the firm, the network firm, or member of the assurance team, and the audit client, or director, officer or controlling owner thereof are both immaterial and the audit client cannot exercise significant influence over the entity. If an interest is material, to either the firm, the network firm or the audit client, and the audit client can exercise significant influence over the entity, no safeguards are available to reduce the threat to an acceptable level and the firm, the network firm, should either dispose of the interest or decline the audit engagement. Any member of the assurance team with such a material interest should either:
- Dispose of the interest;
 - Dispose of a sufficient amount of the interest so that the remaining interest is no longer material; or
 - Withdraw from the audit.

Provisions Applicable to Non-Audit Assurance Clients

- 8.120 If a firm has a direct financial interest in an assurance client that is not an audit client the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.
- 8.121 If a firm has a material indirect financial interest in an assurance client that is not an audit client a self-interest threat is also created. The only action appropriate to permit the firm to perform the engagement would be for the firm to either dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
- 8.122 If a firm has a material financial interest in an entity that has a controlling interest in an assurance client that is not an audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only action appropriate to permit the firm to perform the engagement would be for the firm either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
- 8.123 When a restricted use report for an assurance engagement that is not an audit engagement is issued, exceptions to the provisions in paragraphs 8.104 through 8.108 and 8.120 through 8.122 are set out in 8.15.

Loans and Guarantees

- 8.124 A loan from, or a guarantee thereof by, an assurance client that is a bank or a similar institution, to the firm would not create a threat to independence

provided the loan is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional professional accountant from outside the firm, or network firm, to review the work performed.

- 8.125 A loan from, or a guarantee thereof by, an assurance client that is a bank or a similar institution, to a member of the assurance team or their immediate family would not create a threat to independence provided the loan is made under normal lending procedures, terms and requirements. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.
- 8.126 Similarly, deposits made by, or brokerage accounts of, a firm or a member of the assurance team with an assurance client that is a bank, broker or similar institution would not create a threat to independence provided the deposit or account is held under normal commercial terms.
- 8.127 If the firm, or a member of the assurance team, makes a loan to an assurance client, that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.
- 8.128 Similarly, if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.
- 8.129 The examples in paragraphs 8.124 through 8.128 relate to loans and guarantees between the firm and an assurance client. In the case of an audit engagement, the provisions should be applied to the firm, all network firms and the audit client.

Close Business Relationships with Assurance Clients

- 8.130 A close business relationship between a firm or a member of the assurance team and the assurance client or its management, or between the firm, a network firm and an audit client, will involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:
 - (a) Having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client;

- (b) Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties; and
- (c) Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.

In the case of an audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm, the network firm and the audit client, no safeguards could reduce the threat to an acceptable level. In the case of an assurance client that is not an audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm and the assurance client, no safeguards could reduce the threat to an acceptable level. Consequently, in both these circumstances the only possible courses of action are to:

- Terminate the business relationship;
- Reduce the magnitude of the relationship so that the financial interest is immaterial and the relationship is clearly insignificant; or
- Refuse to perform the assurance engagement.

Unless any such financial interest is immaterial and the relationship is clearly insignificant to the member of the assurance team, the only appropriate safeguard would be to remove the individual from the assurance team.

- 8.131 In the case of an audit client, business relationships involving an interest held by the firm, a network firm or a member of the assurance team or their immediate family in a closely held entity when the audit client or a director or officer of the audit client, or any group thereof, also has an interest in that entity, do not create threats to independence provided:

- The relationship is clearly insignificant to the firm, the network firm and the audit client;
- The interest held is immaterial to the investor, or group of investors; and
- The interest does not give the investor, or group of investors, the ability to control the closely held entity.

- 8.132 The purchase of goods and services from an assurance client by the firm (or from an audit client by a network firm) or a member of the assurance team would not generally create a threat to independence providing the transaction is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Eliminating or reducing the magnitude of the transaction;
- Removing the individual from the assurance team; or
- Discussing the issue with those charged with governance, such as the audit committee.

Family and Personal Relationships

- 8.133 Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual's responsibilities on the assurance engagement, the closeness of the relationship and the role of the family member or other individual within the assurance client. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level.
- 8.134 When an immediate family member of a member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, or was in such a position during any period covered by the engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team. The closeness of the relationship is such that no other safeguard could reduce the threat to independence to an acceptable level. If application of this safeguard is not used, the only course of action is to withdraw from the assurance engagement. For example, in the case of an audit of financial statements, if the spouse of a member of the assurance team is an employee in a position to exert direct and significant influence on the preparation of the audit client's accounting records or financial statements, the threat to independence could only be reduced to an acceptable level by removing the individual from the assurance team.
- 8.135 When a close family member of a member of the assurance team is a director, an officer, or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, threats to independence may be created. The significance of the threats will depend on factors such as:
- The position the close family member holds with the client; and
 - The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Removing the individual from the assurance team;

- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; or
 - Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.
- 8.136 In addition, self-interest, familiarity or intimidation threats may be created when a person who is other than an immediate or close family member of a member of the assurance team has a close relationship with the member of the assurance team and is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement. Therefore, members of the assurance team are responsible for identifying any such persons and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.
- 8.137 Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member of the assurance team and a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement. Therefore partners and employees of the firm are responsible for identifying any such relationships and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship, the interaction of the firm professional with the assurance team, the position held within the firm, and the role of the individual within the assurance client.
- 8.138 An inadvertent violation of this section as it relates to family and personal relationships would not impair the independence of a firm or a member of the assurance team when:
- (a) The firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;
 - (b) Either the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and

(c) Additional care is given to reviewing the work of the professional.

8.139 When an inadvertent violation of this section relating to family and personal relationships has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Employment with Assurance Clients

8.140 A firm or a member of the assurance team's independence may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, a member of the assurance team's independence may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future.

8.141 If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

- The position the individual has taken at the assurance client;
- The amount of any involvement the individual will have with the assurance team;
- The length of time that has passed since the individual was a member of the assurance team or firm; and
- The former position of the individual within the assurance team or firm.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary; or
- Quality control review of the assurance engagement.

In all cases, all of the following safeguards are necessary to reduce the threat to an acceptable level:

- The individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence; and
- The individual does not continue to participate or appear to participate in the firm's business or professional activities.

8.142 A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future. This threat can be reduced to an acceptable level by the application of all of the following safeguards:

- Policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client; and
- Removal of the individual from the assurance engagement.

In addition, consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

Recent Service with Assurance Clients

- 8.143 To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-interest, self-review and familiarity threats. This would be particularly true when a member of the assurance team has to report on, for example, subject matter he or she had prepared or elements of the financial statements he or she had valued while with the assurance client.
- 8.144 If, during the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement, the threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the assurance team.
- 8.145 If, prior to the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement, this may create self-

interest, self-review and familiarity threats. For example, such threats would be created if a decision made or work performed by the individual in the prior period, while employed by the assurance client, is to be evaluated in the current period as part of the current assurance engagement. The significance of the threats will depend upon factors such as:

- The position the individual held with the assurance client;
- The length of time that has passed since the individual left the assurance client; and
- The role the individual plays on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Involving an additional professional accountant to review the work done by the individual as part of the assurance team or otherwise advise as necessary; or
- Discussing the issue with those charged with governance, such as the audit committee.

Serving as an Officer or Director on the Board of Assurance Clients

- 8.146 If a partner or employee of the firm serves as an officer or as a director on the board of an assurance client the self-review and self-interest threats created would be so significant no safeguard could reduce the threats to an acceptable level. In the case of an audit engagement, if a partner or employee of a network firm were to serve as an officer or as a director on the board of an audit client the threats created would be so significant no safeguard could reduce the threats to an acceptable level. Consequently, if such an individual were to accept such a position the only course of action is to refuse to perform, or to withdraw from the assurance engagement.
- 8.147 The position of Company Secretary has different implications in different jurisdictions. The duties may range from administrative duties such as personnel management and the maintenance of company records and registers, to duties as diverse as ensuring that the company complies with regulations or providing advice on corporate governance matters. Generally this position is seen to imply a close degree of association with the entity and may create self-review and advocacy threats.
- 8.148 If a partner or employee of the firm or a network firm serves as Company Secretary for an audit client the self-review and advocacy threats created would generally be so significant, no safeguard could reduce the threat to an acceptable level. When the practice is specifically permitted under local law, professional rules or practice, the duties and functions undertaken should be

limited to those of a routine and formal administrative nature such as the preparation of minutes and maintenance of statutory returns.

- 8.149 Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

Long Association of Senior Personnel with Assurance Clients

General Provisions

- 8.150 Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team;
- The role of the individual on the assurance team;
- The structure of the firm; and
- The nature of the assurance engagement.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- Rotating the senior personnel off the assurance team;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary; or
- Independent internal quality reviews.

Audit Clients that are Listed Entities

- 8.151 Using the same lead engagement partner on an audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the audit of listed entities and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly for the audit of listed entities:

- (a) The lead engagement partner should be rotated after a pre-defined period, normally no more than seven years; and
- (b) A partner rotating after a pre-defined period should not resume the lead engagement partner role until a further period of time, normally two years, has elapsed.

- 8.152 When an audit client becomes a listed entity the length of time the lead engagement partner has served the audit client in that capacity should be considered in determining when the partner should be rotated. However, the

partner may continue to serve as the lead engagement partner for two additional years before rotating off the engagement.

8.153 While the lead engagement partner should be rotated after such a pre-defined period, some degree of flexibility over timing of rotation may be necessary in certain circumstances. Examples of such circumstances include:

- Situations when the lead engagement partner's continuity is especially important to the audit client, for example, when there will be major changes to the audit client's structure that would otherwise coincide with the rotation of the lead engagement partner; and
- Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard.

In all such circumstances when the lead engagement partner is not rotated after such a pre-defined period equivalent safeguards should be applied to reduce any threats to an acceptable level.

8.154 When a firm has only a few audit partners with the necessary knowledge and experience to serve as lead engagement partner on an audit client that is a listed entity, rotation of the lead partner may not be an appropriate safeguard. In these circumstances the firm should apply other safeguards to reduce the threat to an acceptable level. Such safeguards would include involving an additional professional accountant who was not otherwise associated with the assurance team to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or someone within the firm who was not otherwise associated with the assurance team.

Provision of Non-Assurance Services to Assurance Clients

8.155 Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from having these firms, who have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The greater the knowledge of the assurance client's business, the better the assurance team will understand the assurance client's procedures and controls, and the business and financial risks that it faces. The provision of non-assurance services may, however, create threats to the independence of the firm, a network firm or the members of the assurance team, particularly with respect to perceived threats to independence. Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services. In some cases it may be possible to eliminate or reduce the threat created by application of safeguards. In other cases no safeguards are available to reduce the threat to an acceptable level.

8.156 The following activities would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threats to an acceptable level:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so;
- Determining which recommendation of the firm should be implemented; and
- Reporting, in a management role, to those charged with governance.

8.157 The examples set out in paragraphs 8.163 through 8.202 are addressed in the context of the provision of non-assurance services to an assurance client. The potential threats to independence will most frequently arise when a non-assurance service is provided to an audit client. The financial statements of an entity provide financial information about a broad range of transactions and events that have affected the entity. The subject matter of other assurance services, however, may be limited in nature. Threats to independence, however, may also arise when a firm provides a non-assurance service related to the subject matter of a non-audit assurance engagement. In such cases, consideration should be given to the significance of the firm's involvement with the subject matter of the non-audit assurance engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the non-assurance engagement should be declined. When the non-assurance service is not related to the subject matter of the non-audit assurance engagement, the threats to independence will generally be clearly insignificant.

8.158 The following activities may also create self-review or self-interest threats:

- Having custody of an assurance client's assets;
- Supervising assurance client employees in the performance of their normal recurring activities; and
- Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Making arrangements so that personnel providing such services do not participate in the assurance engagement;

- Involving an additional professional accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team; or
 - Other relevant safeguards set out in national regulations.
- 8.159 New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all situations when providing non-assurance services to an assurance client might create threats to independence and of the different safeguards that might eliminate these threats or reduce them to an acceptable level. In general, however, a firm may provide services beyond the assurance engagement provided any threats to independence have been reduced to an acceptable level.
- 8.160 The following safeguards may be particularly relevant in reducing to an acceptable level threats created by the provision of non-assurance services to assurance clients:
- Policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions;
 - Discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee;
 - Policies within the assurance client regarding the oversight responsibility for provision of non-assurance services by the firm;
 - Involving an additional professional accountant to advise on the potential impact of the non-assurance engagement on the independence of the member of the assurance team and the firm;
 - Involving an additional professional accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement;
 - Obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm;
 - Disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged; or
 - Making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.
- 8.161 Before the firm accepts an engagement to provide a non-assurance service to an assurance client, consideration should be given to whether the provision of such a service would create a threat to independence. In situations when a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate safeguards can be applied to eliminate the threat or reduce it to an acceptable level.

- 8.162 The provision of certain non-assurance services to audit clients may create threats to independence so significant that no safeguard could eliminate the threat or reduce it to an acceptable level. However, the provision of such services to a related entity, division or discrete financial statement item of such clients may be permissible when any threats to the firm's independence have been reduced to an acceptable level by arrangements for that related entity, division or discrete financial statement item to be audited by another firm or when another firm re-performs the non-assurance service to the extent necessary to enable it to take responsibility for that service.

Preparing Accounting Records and Financial Statements

- 8.163 Assisting an audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.
- 8.164 It is the responsibility of client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include the following:
- Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the audit client;
 - Authorizing or approving transactions; and
 - Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.
- 8.165 The audit process involves extensive dialogue between the firm and management of the audit client. During this process, management requests and receives significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for audit clients are an appropriate means to promote the fair presentation of the financial statements. The provision of such advice does not generally threaten the firm's independence. Similarly, the audit process may involve assisting an audit client in resolving account reconciliation problems, analyzing and accumulating information for regulatory reporting, assisting in the preparation of consolidated financial statements (including the translation of local statutory accounts to comply with group accounting policies and the transition to a different reporting framework such as International Financial Reporting Standards), drafting disclosure items, proposing adjusting journal entries and providing assistance and advice in the preparation of local statutory accounts

of subsidiary entities. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence.

General Provisions

- 8.166 The examples in paragraphs 8.167 through 8.170 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter of an audit engagement of the firm. This notion may be equally applicable in situations when the subject matter of the assurance engagement is not financial statements. For example, a self-review threat would be created if the firm developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information. Consequently, the firm should evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

Audit Clients that are not Listed Entities

- 8.167 The firm, or a network firm, may provide an audit client that is not a listed entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:

- Recording transactions for which the audit client has determined or approved the appropriate account classification;
- Posting coded transactions to the audit client's general ledger;
- Preparing financial statements based on information in the trial balance; and
- Posting audit client approved entries to the trial balance.

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Making arrangements so such services are not performed by a member of the assurance team;
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client;
- Requiring the source data for the accounting entries to be originated by the audit client;
- Requiring the underlying assumptions to be originated and approved by the audit client; or

- Obtaining audit client approval for any proposed journal entries or other changes affecting the financial statements.

Audit Clients that are Listed Entities

- 8.168 The provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, on behalf of an audit client that is a listed entity, may impair the independence of the firm or network firm, or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services, except in emergency situations and when the services fall within the statutory audit mandate, could reduce the threat created to an acceptable level. Therefore, a firm or a network firm should not, with the limited exceptions below, provide such services to listed entities which are audit clients.
- 8.169 The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of listed audit clients would not be seen as impairing independence with respect to the audit client provided that the following conditions are met:
- The services do not involve the exercise of judgment;
 - The divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client, or the services provided are collectively immaterial to the division or subsidiary; and
 - The fees to the firm, or network firm, from such services are collectively clearly insignificant.

If such services are provided, all of the following safeguards should be applied:

- The firm, or network firm, should not assume any managerial role nor make any managerial decisions;
- The listed audit client should accept responsibility for the results of the work; and
- Personnel providing the services should not participate in the audit.

Emergency Situations

- 8.170 The provision of accounting and bookkeeping services to audit clients in emergency or other unusual situations, when it is impractical for the audit client to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:
- The firm, or network firm, does not assume any managerial role or make any managerial decisions;
 - The audit client accepts responsibility for the results of the work; and

- Personnel providing the services are not members of the assurance team.

Valuation Services

- 8.171 A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.
- 8.172 A self-review threat may be created when a firm or network firms performs a valuation for an audit client that is to be incorporated into the client's financial statements.
- 8.173 If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the audit engagement.
- 8.174 Performing valuation services that are neither separately, nor in the aggregate, material to the financial statements, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary;
 - Confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
 - Obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm; and
 - Making arrangements so that personnel providing such services do not participate in the audit engagement.

In determining whether the above safeguards would be effective, consideration should be given to the following matters:

- The extent of the audit client's knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgment;
- The degree to which established methodologies and professional guidelines are applied when performing a particular valuation service;
- For valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned;

- The reliability and extent of the underlying data;
 - The degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved; and
 - The extent and clarity of the disclosures in the financial statements.
- 8.175 When a firm, or a network firm, performs a valuation service for an audit client for the purposes of making a filing or return to a tax authority, computing an amount of tax due by the assurance client, or for the purpose of tax planning, this would not create a significant threat to independence because such valuations are generally subject to external review, for example by a tax authority.
- 8.176 When the firm performs a valuation that forms part of the subject matter of an assurance engagement that is not an audit engagement, the firm should consider any self-review threats. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

Provision of Taxation Services to Audit Clients

- 8.177 In many jurisdictions, the firm may be asked to provide taxation services to an audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.

Provision of Internal Audit Services to Audit Clients

- 8.178 A self-review threat may be created when a firm, or network firm, provides internal audit services to an audit client. Internal audit services may comprise an extension of the firm's audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.
- 8.179 Services involving an extension of the procedures required to conduct an audit in accordance with International Standards on Auditing would not be considered to impair independence with respect to an audit client provided that the firm's or network firm's personnel do not act or appear to act in a capacity equivalent to a member of audit client management.
- 8.180 When the firm, or a network firm, provides assistance in the performance of a client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and

control of the internal audit by audit client management and the internal audit activities themselves.

- 8.181 Performing a significant portion of the audit client's internal audit activities may create a self-review threat and a firm, or network firm, should consider the threats and proceed with caution before taking on such activities. Appropriate safeguards should be put in place and the firm, or network firm, should, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.
- 8.182 Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:
- (a) The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;
 - (b) The audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;
 - (c) The audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;
 - (d) The audit client is responsible for evaluating and determining which recommendations of the firm should be implemented;
 - (e) The audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and
 - (f) The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.
- 8.183 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the audit engagement and with different reporting lines within the firm.

Provision of IT Systems Services to Audit Clients

- 8.184 The provision of services by a firm or network firm to an audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.
- 8.185 The self-review threat is likely to be too significant to allow the provision of such services to an audit client unless appropriate safeguards are put in place ensuring that:

- (a) The audit client acknowledges its responsibility for establishing and monitoring a system of internal controls;
 - (b) The audit client designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
 - (c) The audit client makes all management decisions with respect to the design and implementation process;
 - (d) The audit client evaluates the adequacy and results of the design and implementation of the system; and
 - (e) The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.
- 8.186 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the audit engagement and with different reporting lines within the firm.
- 8.187 The provision of services by a firm or network firm to an audit client which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may also create a self-review threat. The significance of the threat, if any, should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.
- 8.188 The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to create a threat to independence provided that firm or network firm personnel do not perform management functions.

Temporary Staff Assignments to Audit Clients

- 8.189 The lending of staff by a firm, or network firm, to an audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the firm's or network firm's personnel will not be involved in:
- (a) Making management decisions;
 - (b) Approving or signing agreements or other similar documents; or
 - (c) Exercising discretionary authority to commit the client.

Each situation should be carefully analyzed to identify whether any threats are created and whether appropriate safeguards should be implemented. Safeguards that should be applied in all circumstances to reduce any threats to an acceptable level include:

- The staff providing the assistance should not be given audit responsibility for any function or activity that they performed or supervised during their temporary staff assignment; and
- The audit client should acknowledge its responsibility for directing and supervising the activities of firm, or network firm, personnel.

Provision of Litigation Support Services to Audit Clients

8.190 Litigation support services may include such activities as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.

8.191 A self-review threat may be created when the litigation support services provided to an audit client include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements. The significance of any threat created will depend upon factors such as:

- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned; and
- The nature of the engagement.

The firm, or network firm, should evaluate the significance of any threat created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to perform the service; or
- The involvement of others, such as independent experts.

8.192 If the role undertaken by the firm or network firm involved making managerial decisions on behalf of the audit client, the threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm or network firm should not perform this type of service for an audit client.

Provision of Legal Services to Audit Clients

8.193 Legal services are defined as any services for which the person providing the services must either be admitted to practice before the Courts of the jurisdiction in which such services are to be provided, or have the required legal training to practice law. Legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, litigation, mergers and acquisition advice and support

and the provision of assistance to clients' internal legal departments. The provision of legal services by a firm, or network firm, to an entity that is an audit client may create both self-review and advocacy threats.

- 8.194 Threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entities' financial statements. The safeguards set out in paragraph 8.160 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances when the threat to independence cannot be reduced to an acceptable level the only available action is to decline to provide such services or withdraw from the audit engagement.
- 8.195 The provision of legal services to an audit client which involve matters that would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.
- 8.196 There is a distinction between advocacy and advice. Legal services to support an audit client in the execution of a transaction (*e.g.*, contract support, legal advice, legal due diligence and restructuring) may create self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Such a service would not generally impair independence, provided that:
- Members of the assurance team are not involved in providing the service; and
 - In relation to the advice provided, the audit client makes the ultimate decision or, in relation to the transactions, the service involves the execution of what has been decided by the audit client.
- 8.197 Acting for an audit client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the financial statements of the audit client would create advocacy and self-review threats so significant no safeguard could reduce the threat to an acceptable level. Therefore, the firm should not perform this type of service for an audit client.
- 8.198 When a firm is asked to act in an advocacy role for an audit client in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the financial statements of the audit client, the firm should evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:
- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client; or
 - Using professionals who are not members of the assurance team to perform the service.

- 8.199 The appointment of a partner or an employee of the firm or network firm as General Counsel for legal affairs to an audit client would create self-review and advocacy threats that are so significant no safeguards could reduce the threats to an acceptable level. The position of General Counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, no member of the firm or network firm should accept such an appointment for an audit client.

Recruiting Senior Management

- 8.200 The recruitment of senior management for an assurance client, such as those in a position to affect the subject of the assurance engagement, may create current or future self-interest, familiarity and intimidation threats. The significance of the threat will depend upon factors such as:

- The role of the person to be recruited; and
- The nature of the assistance sought.

The firm could generally provide such services as reviewing the professional qualifications of a number of applicants and provide advice on their suitability for the post. In addition, the firm could generally produce a short-list of candidates for interview, provided it has been drawn up using criteria specified by the assurance client.

The significance of the threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. In all cases, the firm should not make management decisions and the decision as to whom to hire should be left to the client.

Corporate Finance and Similar Activities

- 8.201 The provision of corporate finance services, advice or assistance to an assurance client may create advocacy and self-review threats. In the case of certain corporate finance services, the independence threats created would be so significant no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an assurance client's shares is not compatible with providing assurance services. Moreover, committing the assurance client to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level. In the case of an audit client the provision of those corporate finance services referred to above by a firm or a network firm would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level.

- 8.202 Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate strategies, assisting in identifying or introducing a client to possible

sources of capital that meet the client specifications or criteria, and providing structuring advice and assisting a client in analyzing the accounting effects of proposed transactions. Safeguards that should be considered include:

- Policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to provide the services; and
- Ensuring the firm does not commit the assurance client to the terms of any transaction or consummate a transaction on behalf of the client.

Fees and Pricing

Fees – Relative Size

8.203 When the total fees generated by an assurance client represent a large proportion of a firm's total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as:

- The structure of the firm; and
- Whether the firm is well established or newly created.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the extent and nature of fees charged with the audit committee, or others charged with governance;
- Taking steps to reduce dependency on the client;
- External quality control reviews; and
- Consulting a third party, such as a professional regulatory body or another professional accountant.

8.204 A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Policies and procedures to monitor and implement quality control of assurance engagements; and
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary.

Fees – Overdue

8.205 A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally the payment of such fees should be required before the report is issued. The following safeguards may be applicable:

- Discussing the level of outstanding fees with the audit committee, or others charged with governance; and
- Involving an additional professional accountant who did not take part in the assurance engagement to provide advice or review the work performed.

The firm should also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed.

Pricing

8.206 When a firm obtains an assurance engagement at a significantly lower fee level than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless:

- The firm is able to demonstrate that appropriate time and qualified staff are assigned to the task; and
- All applicable assurance standards, guidelines and quality control procedures are being complied with.

Contingent Fees

8.207 Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them.

8.208 A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement.

8.209 A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. If the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement, the threats could not be reduced to an acceptable level by the application of any safeguard. Accordingly, the only

acceptable action is not to accept such arrangements. For other types of contingent fee arrangements, the significance of the threats created will depend on factors such as:

- The range of possible fee amounts;
- The degree of variability;
- The basis on which the fee is to be determined;
- Whether the outcome or result of the transaction is to be reviewed by an independent third party; and
- The effect of the event or transaction on the assurance engagement.

The significance of the threats should be evaluated and, if the threats are other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threats to an acceptable level. Such safeguards might include:

- Disclosing to the audit committee, or others charged with governance, the extent of nature and extent of fees charged;
- Review or determination of the final fee by an unrelated third party; or
- Quality and control policies and procedures.

Gifts and Hospitality

- 8.210 Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threats. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality.

Actual or Threatened Litigation

- 8.211 When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created. The relationship between client management and the members of the assurance team must be characterized by complete candor and full disclosure regarding all aspects of a client's business operations. The firm and the client's management may be placed in adversarial positions by litigation, affecting management's willingness to make complete disclosures and the firm may face a self-interest threat. The significance of the threat created will depend upon such factors as:

- The materiality of the litigation;
- The nature of the assurance engagement; and
- Whether the litigation relates to a prior assurance engagement.

Once the significance of the threat has been evaluated the following safeguards should be applied, if necessary, to reduce the threats to an acceptable level:

- Disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;
- If the litigation involves a member of the assurance team, removing that individual from the assurance team; or
- Involving an additional professional accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the assurance engagement.

SECTION 9**Professional Competence and Responsibilities Regarding the Use of Non-Accountants**

- 9.1 Professional accountants in public practice should refrain from agreeing to perform professional services which they are not competent to carry out unless competent advice and assistance is obtained so as to enable them to satisfactorily perform such services. If a professional accountant does not have the competence to perform a specific part of the professional service, technical advice may be sought from experts such as other professional accountants, lawyers, actuaries, engineers, geologists, valuers.
- 9.2. In such situations, although the professional accountant is relying on the technical competence of the expert, the knowledge of the ethical requirements cannot be automatically assumed. Since the ultimate responsibility for the professional service rests with the professional accountant, the professional accountant should see that the requirements of ethical behavior are followed.
- 9.3. When using the services of experts who are not professional accountants, the professional accountant must take steps to see that such experts are aware of ethical requirements. Primary attention should be paid to the fundamental principles in paragraph 16 of the Introduction to this Code. These principles would extend to any assignment in which such experts would participate.
- 9.4 The degree of supervision and the amount of guidance that will be needed will depend upon the individuals involved and the nature of the engagement. Examples of such guidance and supervision might include:
- Asking individuals to read the appropriate ethical codes;
 - Requiring written confirmation of understanding of the ethical requirements; and
 - Providing consultation when potential conflicts arise.
- 9.5 The professional accountant should also be alert to specific independence requirements or other risks unique to the engagement. Such situations will require special attention and guidance/supervision to see that ethical requirements are met. For example, Section 8 of this Code requires all professionals participating in the assurance engagement to be independent of the assurance client.
- 9.6 If at any time the professional accountant is not satisfied that proper ethical behavior can be respected or assured, the engagement should not be accepted; or, if the engagement has commenced, it should be terminated.

SECTION 10

Fees and Commissions

- 10.1 Professional accountants in public practice who undertake professional services for a client, assume the responsibility to perform such services with integrity and objectivity and in accordance with the appropriate technical standards. That responsibility is discharged by applying the professional skill and knowledge which professional accountants in public practice have acquired through training and experience. For the services rendered, the **professional accountant in public practice*** is entitled to remuneration.

Professional Fees

- 10.2 Professional fees should be a fair reflection of the value of the professional services performed for the client, taking into account:
- (a) The skill and knowledge required for the type of professional services involved;
 - (b) The level of training and experience of the persons necessarily engaged in performing the professional services;
 - (c) The time necessarily occupied by each person engaged in performing the professional services; and
 - (d) The degree of responsibility that performing those services entails.
- 10.3 Professional fees should normally be computed on the basis of appropriate rates per hour or per day for the time of each person engaged in performing professional services. These rates should be based on the fundamental premise that the organization and conduct of the professional accountant in public practice and the services provided to clients are well planned, controlled and managed. They should take into account the factors set out in paragraph 10.2 and are influenced by the legal, social and economic conditions of each country. It is for each professional accountant in public practice to determine the appropriate rates.
- 10.4 A professional accountant in public practice should not make a representation that specific professional services in current or future periods will be performed for either a stated fee, estimated fee, or fee range if it is likely at the time of the representation that such fees will be substantially increased and the prospective client is not advised of that likelihood.
- 10.5 When performing professional services for a client it may be necessary or expedient to charge a pre-arranged fee, in which event the professional accountant in public practice should estimate a fee taking into account the matters referred to in paragraphs 10.2 through 10.4.

* See Definitions.

- 10.6 It is not improper for a professional accountant in public practice to charge a client a lower fee than has previously been charged for similar services, provided the fee has been calculated in accordance with the factors referred to in paragraphs 10.2 through 10.4.

Commentary

The fact that a professional accountant in public practice secures work by quoting a fee lower than another is not improper. However, professional accountants in public practice who obtain work at fees significantly lower than those charged by an **existing accountant**,* or quoted by others, should be aware that there is a risk of a perception that the quality of work could be impaired.

Accordingly, when deciding on a fee to be quoted to a client for the performance of professional services, a professional accountant should be satisfied that, as a result of the fee quoted:

- The quality of work will not be impaired and that due care will be applied to comply with all professional standards and quality control procedures in the performance of those services, and
- The client will not be misled as to the precise scope of services that a quoted fee is intended to cover and the basis on which future fees will be charged.

- 10.7 As stated in paragraph 8.208:

An assurance engagement should not be performed for a fee that is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement. Paragraph 8.209 provides guidance on threats that may be created if a non-assurance engagement is provide to an assurance client for a contingent fee, and the safeguards that may reduce the threats to an acceptable level.

Commentary

Fees should not be regarded as being contingent if fixed by a court or other public authority. Fees charged on a percentage or similar basis, except when authorized by statute or approved by a member body as generally accepted practice for certain professional services, should be regarded as contingent fees.

- 10.8 The foregoing paragraphs relate to fees as distinct from reimbursement of expenses. Out-of-pocket expenses, in particular traveling expenses, attributable directly to the professional services performed for a particular client would normally be charged to that client in addition to the professional fees.
- 10.9 It is in the best interests of both the client and the professional accountant in public practice that the basis on which fees are computed and any billing

* See Definitions.

arrangements are clearly defined, preferably in writing, before the commencement of the engagement to help in avoiding misunderstandings with respect to fees. (For further guidance, refer to International Standard on Auditing 210 “Terms of Audit Engagements.”)

Commissions

- 10.10 In those countries where payment and receipt of commissions are permitted, either by statute or by a member body, and the professional accountant in public practice accepts such a commission this fact should be disclosed to the client.
- 10.11 Subject to paragraph 10.10, a professional accountant in public practice should not pay a commission to obtain a client nor should a commission be accepted for referral of a client to a third party. A professional accountant in public practice should not accept a commission for the referral of the products or services of others.
- 10.12 Payment and receipt of referral fees between professional accountants in public practice when no services are performed by the referring accountant are regarded as commissions for the purpose of paragraph 10.11.
- 10.13 A professional accountant in public practice may enter into an arrangement for the purchase of the whole or part of an accounting practice requiring payments to individuals formerly engaged in the practice or payments to their heirs or estates. Such payments are not regarded as commissions for the purpose of paragraph 10.10.

SECTION 11

Activities Incompatible with the Practice of Public Accountancy

- 11.1 A professional accountant in public practice should not concurrently engage in any business, occupation or activity which impairs or might impair integrity, objectivity or independence, or the good reputation of the profession and therefore would be incompatible with the rendering of professional services.
- 11.2 The rendering of two or more types of professional services concurrently does not by itself impair integrity, objectivity or independence.
- 11.3 The simultaneous engagement in another business, occupation or activity unrelated to professional services which has the effect of not allowing the professional accountant in public practice properly to conduct a professional practice in accordance with the fundamental ethical principles of the accountancy profession should be regarded as inconsistent with the practice of public accountancy.

SECTION 12

Clients' Monies

- 12.1 It is recognized that in some countries the law does not permit a professional accountant in public practice to hold **clients' monies**,* in other countries there are legal duties imposed on professional accountants in public practice who do hold such monies. The professional accountant in public practice should not hold clients' monies if there is reason to believe that they were obtained from, or are to be used for, illegal activities.
- 12.2 A professional accountant in public practice entrusted with monies belonging to others should:
- (a) Keep such monies separately from personal or firm monies;
 - (b) Use such monies only for the purpose for which they are intended; and
 - (c) At all times, be ready to account for those monies to any persons entitled to such accounting.
- 12.3 A professional accountant in public practice should maintain one or more bank accounts for clients' monies. Such bank accounts may include a general **client account*** into which the monies of a number of clients may be paid.
- 12.4 Clients' monies received by a professional accountant in public practice should be deposited without delay to the credit of a client account, or – if in the form of documents of title to money and documents of title which can be converted into money – be safeguarded against unauthorized use.
- 12.5 Monies may only be drawn from the client account on the instructions of the client.
- 12.6 Fees due from a client may be drawn from client's monies provided the client, after being notified of the amount of such fees, has agreed to such withdrawal.
- 12.7 Payments from a client account shall not exceed the balance standing to the credit of the client.
- 12.8 When it seems likely that the client's monies remain on client account for a significant period of time, the professional accountant in public practice should, with the concurrence of the client, place such monies in an interest bearing account within a reasonable time.
- 12.9 All interest earned on clients' monies should be credited to the client account.
- 12.10 Professional accountants in public practice should keep such books of account as will enable them, at any time, to establish clearly their dealings with clients' monies in general and the monies of each individual client in particular. A statement of account should be provided to the client at least once a year.

* See Definitions.

SECTION 13

Relations with Other Professional Accountants in Public Practice

Accepting New Assignments

- 13.1 The extension of the operations of a business undertaking frequently results in the formation of branches or subsidiary companies at locations where an **existing accountant*** does not practice. In these circumstances, the client or the existing accountant in consultation with the client may request a **receiving accountant*** practicing at those locations to perform such professional services as necessary to complete the assignment.
- 13.2 Referral of business may also arise in the area of special services or special tasks. The scope of the services offered by professional accountants in public practice continues to expand and the depth of knowledge which is needed to serve the public often calls for special skills. Since it is impracticable for any one professional accountant in public practice to acquire special expertise or experience in all fields of accountancy, some professional accountants in public practice have decided that it is neither appropriate nor desirable to develop within their firms the complete range of special skills which may be required.
- 13.3 Professional accountants in public practice should only undertake such services which they can expect to complete with professional competence. It is essential therefore for the profession in general and in the interests of their clients that professional accountants in public practice be encouraged to obtain advice when appropriate from those who are competent to provide it.
- 13.4 An existing accountant without a particular skill may however be reluctant to refer a client to another professional accountant in public practice who may possess that skill, because of the fear of losing existing business to the other professional accountant in public practice. As a result, clients may be deprived of the benefit of advice which they are entitled to receive.
- 13.5 The wishes of the client should be paramount in the choice of professional advisers, whether or not special skills are involved. Accordingly, a professional accountant in public practice should not attempt to restrict in any way the client's freedom of choice in obtaining special advice, and when appropriate should encourage a client to do so.
- 13.6 The services or advice of a professional accountant in public practice having special skills may be sought in one or other of the following ways:
 - (a) By the client;
 - (i) After prior discussion and consultation with the existing accountant;
 - (ii) On the specific request or recommendation of the existing accountant; and

* See Definitions.

- (iii) Without reference to the existing accountant; or
 - (b) By the existing accountant with due observance of the duty of confidentiality.
- 13.7 When a professional accountant in public practice is asked to provide services or advice, inquiries should be made as to whether the prospective client has an existing accountant. In cases where there is an existing accountant who will continue to provide professional services, the procedures set out in paragraphs 13.8–13.14 should be observed. If the appointment will result in another professional accountant in public practice being superseded, the procedures set out in paragraphs 13.15–13.26 should be followed.
- 13.8 The receiving accountant should limit the services provided to the specific assignment received by referral from the existing accountant or the client unless otherwise requested by the client. The receiving accountant also has the duty to take reasonable steps to support the existing accountant's current relationship with the client and should not express any criticism of the professional services of the existing accountant without giving the latter an opportunity to provide all relevant information.
- 13.9 A receiving accountant who is asked by the client to undertake an assignment of a type which is clearly distinct from that being carried out by the existing accountant or from that initially received by referral from the existing accountant or from the client, should regard this as a separate request to provide services or advice. Before accepting any appointments of this nature, the receiving accountant should advise the client of the professional obligation to communicate with the existing accountant and should immediately do so preferably in writing, advising of the approach made by the client and the general nature of the request as well as seeking all relevant information, if any, necessary to perform the assignment.
- 13.10 Circumstances sometimes arise when the client insists that the existing accountant should not be informed. In this case, the receiving accountant should decide whether the client's reasons are valid. In the absence of special circumstances a mere disinclination by the client for communication with the existing accountant would not be a satisfactory reason.
- 13.11 The receiving accountant should:
 - (a) Comply with the instructions received from the existing accountant or the client to the extent that they do not conflict with relevant legal or other requirements; and
 - (b) Ensure, insofar as it is practicable to do so, that the existing accountant is kept informed of the general nature of the professional services being performed.
- 13.12 When there are two or more other professional accountants in public practice performing professional services for the client concerned it may be appropriate

to notify only the relevant professional accountant in public practice depending on the specific services being performed.

- 13.13 When appropriate the existing accountant, in addition to issuing instructions concerning referred business, should maintain contact with the receiving accountants and cooperate with them in all reasonable requests for assistance.
- 13.14 When the opinion of a professional accountant, other than the existing accountant, is sought on the application of accounting, auditing, reporting or other standards or principles to specific circumstances or transactions, the professional accountant should be alert to the possibility of the opinion creating undue pressure on the judgment and objectivity of the accountant. An opinion given without full and proper facts can cause difficulty to the receiving accountant if the opinion is challenged or the receiving accountant is subsequently appointed by the company. Accordingly, the professional accountant should seek to minimize the risk of giving inappropriate guidance by ensuring that he or she has access to all relevant information. When there is a request for an opinion in the above circumstances there is a requirement for communication with the existing accountant. It is important that the existing accountant, with the permission of the client, provide the receiving accountant with all requested relevant information about the client. With the permission of the client, the receiving accountant should also provide a copy of the final report to the existing accountant. If the client does not agree to these communications, then the engagement should ordinarily not be performed.

Superseding Another Professional Accountant in Public Practice

- 13.15 The proprietors of a business have an indisputable right to choose their professional advisers and to change to others should they so desire. While it is essential that the legitimate interests of the proprietors are protected, it is also important that a professional accountant in public practice who is asked to replace another professional accountant in public practice has the opportunity to ascertain if there are any professional reasons why the appointment should not be accepted. This cannot effectively be done without direct communication with the existing accountant. In the absence of a specific request, the existing accountant should not volunteer information about the client's affairs.
- 13.16 Communication enables a professional accountant in public practice to ascertain whether the circumstances in which a change in appointment is proposed are such that the appointment can properly be accepted and also whether there is a wish to undertake the engagement. In addition, such communication helps to preserve the harmonious relationships which should exist between all professional accountants in public practice on whom clients rely for professional advice and assistance.
- 13.17 The extent to which an existing accountant can discuss the affairs of the client with the proposed professional accountant in public practice depend on:
 - (a) Whether the client's permission to do so has been obtained; and/or

- (b) The legal or ethical requirements relating to such disclosure which may vary by country.
- 13.18 The proposed professional accountant in public practice should treat in the strictest confidence and give due weight to any information provided by the existing accountant.
- 13.19 The information provided by the existing accountant may indicate, for example, that the ostensible reasons given by the client for the change are not in accordance with the facts. It may disclose that the proposal to make a change in professional accountants in public practice was made because the existing accountants stood their ground and properly carried out the duties as professional accountants in public practice despite opposition or evasion on an occasion on which important differences of principles or practice have arisen with the client.
- 13.20 Communication between the parties therefore serves:
 - (a) To protect a professional accountant in public practice from accepting an appointment in circumstances where all the pertinent facts are not known.
 - (b) To protect the minority proprietors of a business who may not be fully informed of the circumstances in which the change is proposed.
 - (c) To protect the interests of the existing accountant when the proposed change arises from, or is an attempt to interfere with, the conscientious exercise of the existing accountant's duty to act as an independent professional.
- 13.21 Before accepting an appointment involving recurring professional services hitherto carried out by another professional accountant in public practice, the proposed professional accountant in public practice should:
 - (a) Ascertain if the prospective client has advised the existing accountant of the proposed change and has given permission, preferably in writing, to discuss the client's affairs fully and freely with the proposed professional accountant in public practice.
 - (b) When satisfied with the reply received from prospective client, request permission to communicate with the existing accountant. If such permission is refused or the permission referred to in (a) above is not given, the proposed professional accountant in public practice should, in the absence of exceptional circumstances of which there is full knowledge, and unless there is satisfaction as to necessary facts by other means, decline the appointment.
 - (c) On receipt of permission, ask the existing accountant, preferably in writing:
 - (i) To provide information on any professional reasons which should be known before deciding whether or not to accept the appointment and, if there are such matters; and

(ii) To provide all the necessary details to be able to come to a decision.

- 13.22 The existing accountant, on receipt of the communication referred to in paragraph 13.21 (c) should forthwith:
- (a) Reply, preferably in writing, advising whether there are any professional reasons why the proposed professional accountant in public practice should not accept the appointment.
 - (b) If there are any such reasons or other matters which should be disclosed, ensure that the client has given permission to give details of this information to the proposed professional accountant in public practice. If permission is not granted, the existing accountant should report that fact to the proposed professional accountant in public practice.
 - (c) On receipt of permission from the client, disclose all information needed by the proposed professional accountant in public practice to be able to decide whether or not to accept the appointment, and discuss freely with the proposed professional accountant in public practice all matters relevant to the appointment of which the latter should be aware.
- 13.23 If the proposed professional accountant in public practice does not receive, within a reasonable time, a reply from the existing accountant and there is no reason to believe that there are any exceptional circumstances surrounding the proposed change, the proposed professional accountant in public practice should endeavor to communicate with the existing accountant by some other means. If unable to obtain a satisfactory outcome in this way, the proposed professional accountant in public practice should send a further letter, stating that there is an assumption that there is no professional reason why the appointment should not be accepted and that there is an intention to do so.
- 13.24 The fact that there may be fees owing to the existing accountant is not a professional reason why another professional accountant in public practice should not accept the appointment.
- 13.25 The existing accountant should promptly transfer to the new professional accountant in public practice all books and papers of the client which are or may be held after the change in appointment has been effected and should advise the client accordingly, unless the professional accountant in public practice has a legal right to withhold them.
- 13.26 Certain organizations, either because of legislative requirements or otherwise, call for submissions or tenders, *e.g.*, competitive bids, in relation to professional services offered by accountants in public practice. In reply to a public advertisement or an unsolicited request to make a submission or submit a tender, a professional accountant in public practice should, if the appointment may result in the replacement of another professional accountant in public practice, state in the submission or tender that before acceptance the opportunity to contact the other professional accountant in public practice is required so that inquiries may be made as to whether there are any professional

reasons why the appointment should not be accepted. If the submission or tender is successful, the existing accountant should then be contacted.

SECTION 14

Advertising and Solicitation

- 14.1 Whether or not **advertising*** and **solicitation*** by individual professional accountants in public practice are permitted is a matter for member bodies to determine based upon the legal, social and economic conditions in each country.
- 14.2 When permitted, such advertising and solicitation should be aimed at informing the public in an objective manner and should be decent, honest, truthful and in good taste. Solicitation by the use of coercion or harassment should be prohibited.
- 14.3 Examples of activities which may be considered not to meet the above criteria include those that:
 - (a) Create false, deceptive or unjustified expectations of favorable results;
 - (b) Imply the ability to influence any court, tribunal, regulatory agency or similar body or official;
 - (c) Consist of self-laudatory statements that are not based on verifiable facts;
 - (d) Make comparisons with other professional accountants in public practice;
 - (e) Contain testimonials or endorsements;
 - (f) Contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived; and
 - (g) Make unjustified claims to be an expert or specialist in a particular field of accountancy.
- 14.4 A professional accountant in public practice in a country where advertising is permitted should not seek to obtain an advantage by advertising in newspapers or magazines published or distributed in a country where advertising is prohibited. Similarly, a professional accountant in public practice in a country where advertising is prohibited should not advertise in a newspaper or magazine published in a country where advertising is permitted.
- 14.5 In situations where professional accountants in public practice in their international cross border activities violate the provisions of paragraph 14.4, contact should take place between the member body in the country in which the violation takes place and the member body of the home country of the professional accountant in public practice to ensure that the member body in the home country is made aware of such violation.
- 14.6 It is clearly desirable that the public should be aware of the range of services available from a professional accountant. Accordingly there is no objection to

* See Definitions.

a member body communicating such information to the public on an institutional basis, *i.e.*, in the name of the member body.

Publicity by Professional Accountants in Public Practice in a Non-Advertising Environment

- 14.7 When advertising is not permitted, publicity by individual professional accountants in public practice is acceptable provided:
- (a) It has as its object the notification to the public or such sectors of the public as are concerned, of matters of fact in a manner that is not false, misleading or deceptive;
 - (b) It is in good taste;
 - (c) It is professionally dignified; and
 - (d) It avoids frequent repetition of, and any undue prominence being given to the name of the professional accountant in public practice.
- 14.8 The examples which follow are illustrative of circumstances in which publicity is acceptable and the matters to be considered in connection therewith subject always to the overriding requirements mentioned in the preceding paragraph.

Appointments and Awards

It is in the interests of the public and the accountancy profession that any appointment or other activity of a professional accountant in a matter of national or local importance, or the award of any distinction to a professional accountant, should receive publicity and that membership of the professional body should be mentioned. However, the professional accountant should not make use of any of the aforementioned appointments or activities for personal professional advantage.

Professional Accountants Seeking Employment or Professional Business

A professional accountant may inform interested parties through any medium that a partnership or salaried employment of an accountancy nature is being sought. The professional accountant should not, however, publicize for subcontract work in a manner which could be interpreted as seeking to procure professional business. Publicity seeking subcontract work may be acceptable if placed only in the professional press and provided that neither the professional accountant's name, address or telephone number appears in the publicity. A professional accountant may write a letter or make a direct approach to another professional accountant when seeking employment or professional business.

Directories

A professional accountant may be listed in a directory provided neither the directory itself nor the entry could reasonably be regarded as a promotional advertisement for those listed therein. Entries should be limited to name, address, telephone number, professional description and any other information

necessary to enable the user of the directory to make contact with the person or organization to which the entry relates.

Books, Articles, Interviews, Lectures, Radio and Television Appearances

Professional accountants who author books or articles on professional subjects, may state their name and professional qualifications and give the name of their organization but shall not give any information as to the services that firm provides.

Similar provisions are applicable to participation by a professional accountant in a lecture, interview or a radio or television program on a professional subject. What professional accountants write or say, however, should not be promotional of themselves or their firm but should be an objective professional view of the topic under consideration. Professional accountants are responsible for using their best endeavors to ensure that what ultimately goes before the public complies with these requirements.

Training Courses, Seminars, *etc.*

A professional accountant may invite clients, staff or other professional accountants to attend training courses or seminars conducted for the assistance of staff. Other persons should not be invited to attend such training courses or seminars except in response to an unsolicited request. The requirement should in no way prevent professional accountants from providing training services to other professional bodies, associations or educational institutions which run courses for their members or the public. However, undue prominence should not be given to the name of a professional accountant in any booklets or documents issued in connection therewith.

Booklets and Documents Containing Technical Information

Booklets and other documents bearing the name of a professional accountant and giving technical information for the assistance of staff or clients may be issued to such persons or to other professional accountants.

Other persons should not be issued with such booklets or documents except in response to an unsolicited request.

Staff Recruitment

Genuine vacancies for staff may be communicated to the public through any medium in which comparable staff vacancies normally appear. The fact that a job specification necessarily gives some detail as to one or more of the services provided to clients by the professional accountant in public practice is acceptable but it should not contain any promotional element. There should not be any suggestion that the services offered are superior to those offered by other professional accountants in public practice as a consequence of size, associations, or for any other reason.

In publications such as those specifically directed to schools and other places of education to inform students and graduates of career opportunities in the

profession, services offered to the public may be described in a businesslike way.

More latitude may also be permissible in a section of a newspaper devoted to staff vacancies than would be allowed if the vacancy appeared in a prominent position elsewhere in a newspaper on the grounds that it would be most unlikely that a potential client would use such media to select a professional adviser.

Publicity on Behalf of Clients

A professional accountant in public practice may publicize on behalf of clients, primarily for staff. However, the professional accountant in public practice should ensure that the emphasis in the publicity is directed towards the objectives to be achieved for the client.

Brochures and Firm Directories

A professional accountant in public practice may issue to clients or, in response to an unsolicited request, to a non-client:

- (a) A factual and objectively worded account of the services provided; and
- (b) A directory setting out names of partners, office addresses and names and addresses of associated firms and correspondents.

Stationery and Nameplates

Stationery of professional accountants in public practice should be of an acceptable professional standard and comply with the requirements of the law and of the member body concerned as to names of partners, principals and others who participate in the practice, use of professional descriptions and designatory letters, cities or countries where the practice is represented, logotypes, *etc.* The designation of any services provided by the practice as being of specialist nature should not be permitted. Similar provisions, where applicable, should apply to nameplates.

Newspaper Announcements

Appropriate newspapers or magazines may be used to inform the public of the establishment of a new practice, of changes in the composition of a partnership of professional accountants in public practice, or of any alteration in the address of a practice.

Such announcements should be limited to a bare statement of facts and consideration given to the appropriateness of the area of distribution of the newspaper or magazine and number of insertions.

Inclusion of the Name of a Professional Accountant in Public Practice in a Document Issued by a Client

When a client proposes to publish a report by a professional accountant in public practice dealing with the client's existing business affairs or in

connection with the establishment of a new business venture, the professional accountant in public practice should take steps to ensure that the context in which the report is published is not such as might result in the public being misled as to the nature and meaning of the report. In these circumstances, the professional accountant in public practice should advise the client that permission should first be obtained before publication of the document.

Similar consideration should be given to other documents proposed to be issued by a client containing the name of a professional accountant in public practice acting in an independent professional capacity. This does not preclude the inclusion of the name of a professional accountant in public practice in the annual report of a client.

When professional accountants in their private capacity are associated with, or hold office in, an organization, the organization may use their name and professional status on stationery and other documents. The professional accountant in public practice should ensure that this information is not used in such a way as might lead the public to believe that there is a connection with the organization in an independent professional capacity.

PART C — APPLICABLE TO EMPLOYED PROFESSIONAL ACCOUNTANTS

The following sections contain guidance which is particularly relevant to professional accountants working in industry, commerce, the public sector or education. Professional accountants employed in public practice should be aware they may find that the principles set out below are also of application to their particular circumstances. If professional accountants employed in practice are in doubt as to the applicability of any particular guidance, they should seek assistance from their professional body.

SECTION 15

Conflict of Loyalties

- 15.1 Employed professional accountants owe a duty of loyalty to their employer as well as to their profession and there may be times when the two are in conflict. An employee's normal priority should be to support his or her organization's legitimate and ethical objectives and the rules and procedures drawn up in support of them. However, an employee cannot legitimately be required to:
- (a) Break the law;
 - (b) Breach the rules and standards of their profession;
 - (c) Lie to or mislead (including misleading by keeping silent) those acting as auditors to the employer; or
 - (d) Put their name to or otherwise be associated with a statement which materially misrepresents the facts.
- 15.2 Differences in view about the correct judgment on accounting or ethical matters should normally be raised and resolved within the employee's organization, initially with the employee's immediate superior and possibly thereafter, where disagreement about a significant ethical issue remains, with higher levels of management or non executive directors.
- 15.3 If employed accountants cannot resolve any material issue involving a conflict between their employers and their professional requirements they may, after exhausting all other relevant possibilities, have no other recourse but to consider resignation. Employees should state their reasons for doing so to the employer but their duty of confidentiality normally precludes them from communicating the issue to others (unless legally or professionally required to do so).
- 15.4 For further guidance as to the considerations involved see Section 2—Resolution of Ethical Conflicts.

SECTION 16

Support for Professional Colleagues

- 16.1 A professional accountant, particularly one having authority over others, should give due weight for the need for them to develop and hold their own judgment in accounting matters and should deal with differences of opinion in a professional way.

SECTION 17

Professional Competence

- 17.1 A professional accountant employed in industry, commerce, the public sector or education may be asked to undertake significant tasks for which he or she has not had sufficient specific training or experience. When undertaking such work the professional accountant should not mislead the employer as to the degree of expertise or experience he or she possesses, and where appropriate expert advice and assistance should be sought.

SECTION 18

Presentation of Information

- 18.1 A professional accountant is expected to present financial information fully, honestly and professionally and so that it will be understood in its context.
- 18.2 Financial and non-financial information should be maintained in a manner that describes clearly the true nature of business transactions, assets or liabilities and classifies and records entries in a timely and proper manner, and professional accountants should do everything that is within their powers to ensure that this is the case.

STATEMENT OF POLICY OF COUNCIL*

PREFACE TO ETHICAL REQUIREMENTS OF (NAME OF MEMBER BODY)

This Preface has been approved by the Council of the [Name of Member Body] for publication.

1. The [Name of Member Body] as a member of the International Federation of Accountants (IFAC) is committed to the IFAC's broad objective of developing and enhancing a coordinated worldwide accountancy profession with harmonized standards. In working toward this objective, IFAC develops guidance on ethics for professional accountants. IFAC believes that issuing such guidance will improve the degree of uniformity of professional ethics throughout the world.
2. As a condition of its membership, the [Name of Member Body] is obliged to support the work of IFAC by informing its members of every pronouncement developed by IFAC, and to work towards implementation, when and to the extent possible under local circumstances, of those pronouncements.
3. The [Name of Member Body] has determined to (either 1 or 2):
 1. Adopt the IFAC Code of Ethics for Professional Accountants as the ethical requirements in [Name of Country]. The Council of [Name of Member Body] has prepared an explanatory foreword (attachment A) which sets out the status and effective date of this decision.
 2. Adopt the IFAC Code of Ethics for Professional Accountants as the basis for approved ethical requirements in [Name of Country]. The Council of [Name of Member Body] has prepared an explanatory foreword (attachment B) which sets out the status and effective date of this decision along with significant differences between the IFAC guidance and the law or practice in [Name of Country] and how such differences have been resolved.

An explanatory foreword will be issued on the status of each additional IFAC pronouncement on Ethics that is adopted by the Council of [Name of Member Body]. Where the Council of [Name of Member Body] deems it necessary, additional ethical requirements may be developed on matters of relevance in [Name of Country] not covered by an IFAC pronouncement.

4. Members of [Name of Member Body] are expected to comply with the ethical requirements issued by [Name of Member Body]. Apparent failure to do so

* Effective May 2000 the IFAC Council was renamed the IFAC Board.

ETHICS

may result in an investigation into the member's conduct by [Name of Appropriate Disciplinary Committee of Member Body].

5. It is not practical to establish ethical requirements which apply to all situations and circumstances that professional accountants may encounter. Therefore, professional accountants should consider the ethical requirements as the basic principles which they should follow in performing their work.
6. The date from which members are expected to observe pronouncements on ethics is set out in the explanatory foreword.

Attachment A

Code of Ethics for Professional Accountants

[Title]

Explanatory Foreword

The Council of [Name of Member Body] has determined that this Code should be adopted. This Code is mandatory for all members of [Name of Member Body] to observe in respect of professional services performed in [Name of Country] after [Month, Day, Year].

Attachment B

Code of Ethics for Professional Accountants

[Title]

Explanatory Foreword

The Council of [Name of Member Body] has determined that this Code should be adopted with the explanatory notes below. This Code is mandatory for all members of [Name of Member Body] to observe in respect of the performance of professional services in [Name of Country] after [Month, Day, Year].

Section 14 Under [Name of Country] legislation, professional accountants are not permitted to advertise their services. Thus paragraphs 14.2 and 14.3 are not relevant in [Name of Country].

STATEMENT OF POLICY OF COUNCIL^{*}

IMPLEMENTATION AND ENFORCEMENT OF ETHICAL REQUIREMENTS

Introduction

1. The mission of the International Federation of Accountants (IFAC) as set out in paragraph 2 of its Constitution is “the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide services of consistently high quality in the public interest.” In working towards this objective, the Council of IFAC has established committees to develop and issue pronouncements on behalf of the Council on a wide variety of professional issues.
2. IFAC believes that the issues of such pronouncements will help improve the degree of uniformity of the accountancy profession throughout the world. However, it should be recognized that in order to develop such pronouncements the legal, social and economic conditions prevailing in each country will affect the extent and manner in which the pronouncements are applied. Notwithstanding this condition, it is important that each national profession have a set of clearly articulated pronouncements and technical standards to cover the professional practice of accounting.
3. Once the relevant pronouncements are implemented they should be governed by a policy which ensures that the ethical requirements (which includes compliance with technical standards) are followed.
4. The Council of IFAC wishes to draw the attention of member bodies to the following Statement of Policy on Implementation and Enforcement of Ethical Requirements.

Implementation of Ethical Requirements

5. The task of preparing detailed ethical requirements is primarily that of the professional bodies of each country concerned, even if the responsibility for promulgating those requirements is assumed, partly or wholly by the legislative body of that country.
6. The adoption of ethical requirements by member bodies will not necessarily ensure that the standard of conduct laid down will be maintained; if it is to be effective, provision must be made by the appropriate bodies in each country for their implementation.

^{*} Effective May 2000 the IFAC Council was renamed the IFAC Board.

7. Each member body has the responsibility to promote the high standards of professional conduct and to ensure that ethical requirements are observed and failure to observe them will be investigated and appropriate action taken.

As noted in paragraph 2.6 of the *Code of Ethics for Professional Accountants*, member bodies are encouraged to ensure that counseling and advice is available to help resolve ethical conflicts. This function is an important part of implementation and can be fulfilled by such means as providing a service to respond to questions raised by individual members on interpretations of ethical requirements or by the formation of appropriate committees within member bodies which would monitor the ethical requirements of those bodies.

Provision of an interpretation/advice/counseling service should offer the following features:

- Its purpose and operating procedures should be transparent and widely promoted to the membership;
 - The operating procedures should provide safeguards such that only reasonable questions from members are considered and that the questioner is responsible for clearly setting out the facts and circumstances;
 - The individuals charged with responsibility for providing the advice must be at a level commensurate with such authority and have sufficient technical expertise to provide such advice;
 - Inquiries would ordinarily be made on a totally confidential basis; and
 - Results of any interpretation/counseling/advice questions could be subject to publication (on a “no-name” basis) to the general membership as an educational method.
8. Implementation of ethical requirements will be assisted by the introduction of a program designed to ensure that individual members are aware of all ethical requirements and the consequences of non-compliance with those requirements. This information may be communicated to individual members in such ways as members’ handbooks, technical releases, professional journals, reports on disciplinary hearings and activities, programs of continuing professional education, newsletters, financial and business press, and responses from the appropriate committee to requests for advice.
 9. Most accountants will respect the ethical requirements to which they are subject without any necessity for compulsion or sanctions. Nevertheless, cases may occur where such requirements are flagrantly ignored or where accountants through error, oversight or lack of understanding, fail to observe them. It is in the interest of the profession and all its members in any country that the general public should have confidence that failure to observe the ethical requirements of the profession in that country will be investigated and, where appropriate, disciplinary action taken.

10. Members of member bodies should therefore be prepared to justify any departures from the ethical requirements. Failure to comply with ethical requirements or the inability to justify departures therefrom may constitute professional misconduct that could give rise to disciplinary action.

Enforcement of Ethical Requirements

11. The power for disciplinary action may be provided by legislation or by the constitution of the professional body. In many countries, disciplinary action may be provided by legislative agencies other than the professional body. Such regulatory agencies may be jointly or solely responsible for the disciplinary action or provide a review process over disciplinary action already taken.
12. Disciplinary action ordinarily arises from such issues as:
 - Failure to observe the required standard of professional care, skills or competence;
 - Non-compliance with rules of ethics; and
 - Discreditable or dishonorable conduct.
13. Disciplinary investigations will ordinarily commence as a result of a complaint. Member bodies should consider all complaints. Investigations may, however, be initiated by the member body or regulatory agency without a complaint being made. Investigations can be carried out on a verbal or correspondence basis. Reference should always be made to the member body against whom the complaint is being made as well as to the complainant. When there is a dispute, conciliation may be attempted. Setting time limits on the investigatory process may be difficult, particularly when the circumstances involve other legal processes.
14. Arising from the investigatory process, the member body or regulatory agency will decide as to whether to commence disciplinary proceedings. There may be a right to appeal, within a set time frame, against the decision.
15. The disciplinary proceedings will ordinarily be carried out by the disciplinary committee or similar tribunal. The proceedings should be held in a manner which is consistent with the legal requirements of the country concerned. This will ordinarily involve legal representation, taking evidence and keeping records of the proceedings. The case against the defendant may be presented by a lawyer, a representative of the investigation committee or the secretariat of the member body.
16. Sanctions commonly imposed by disciplinary bodies include the following:
 - Reprimand;
 - Fine;
 - Payment of costs;
 - Withdrawal of practicing rights;

- Suspension; and
- Expulsion from membership.

Other sanctions can include a warning, the refund of the fee charged to the client, additional education and the work to be complete by another member at the disciplined member's expense.

17. Ordinarily there is a right to appeal by both sides within fixed time limits. Such a right of appeal may be to a body not connected with the member body. Consideration should be given to the inclusion of nonmembers in the body of appeal and the appointment of a nonmember as the chairman. The appeal body should review all the evidence considered at the disciplinary proceedings. Additional evidence may also be called for and taken either orally or in writing.
18. It may be appropriate for publicity to be given to the disciplinary and appeal proceedings. In this way, both members and the general public are informed. However, the aspects of confidentiality and the type of violation have to be considered in deciding the method of publicity. There may also be a need to communicate the decision to an appropriate regulatory body or vice versa where the regulatory body has carried out the disciplinary hearing.

AUDITING AND ASSURANCE

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INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD—PROPOSED¹ TERMS OF REFERENCE

The objective of the International Auditing and Assurance Standards Board (IAASB), on behalf of the IFAC Board, is to improve auditing and assurance standards and the quality and uniformity of practice throughout the world, thereby strengthening public confidence in the global auditing profession and serving the public interest, by:

- Establishing auditing standards and guidance for financial statement audits of such high quality that they are acceptable to investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world.
- Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters.
- Establishing standards and guidance for other related services.
- Establishing quality control standards covering the scope of services addressed by the Board.
- Publishing other papers on auditing and assurance matters, thereby advancing the public understanding of the roles and responsibility of professional auditors and assurance service providers.

The IAASB issues “International Standards on Auditing” (ISA) as the standards to be applied in reporting on the credibility of historic financial information. It also issues International Standards on Assurance Engagements (ISAE) Quality Control (ISQC) and Related Services (ISRS) as it considers appropriate.

The IAASB issues Practice Statements as appropriate to provide practical assistances in implementing its standards and to promote good practice.

The IAASB cooperates with national standard-setters to link their work with IAASB’s own in preparing and issuing standards. It also promotes the endorsement of ISAs by legislators and securities exchanges and promotes debate with users, regulators and practitioners throughout the world to identify user needs for new standards and guidance.

Each member of the IAASB has one vote. The affirmative vote of at least two-thirds of members present at a meeting in person or by proxy or by simultaneous telecommunications link, but not less than twelve, is required to approve standards.

IAASB meetings to discuss the development of standards, guidance or other papers are open to the public. Agenda papers are published on the IFAC web site.

¹ An exposure draft containing the proposed “Terms of Reference,” a revised “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services” and Operations Policy No 1, “Bold Type Lettering,” was issued by the IAASB in November 2002. The final “Terms of Reference” will be issued in 2003 and will be available on the IAASB website at <http://www.iaasb.org>.

IAASB publishes an annual report, outlining its work program and activities during the year.

IFAC will review the effectiveness of IAASB's processes at least every three years.

PROPOSED¹ PREFACE TO THE INTERNATIONAL STANDARDS ON QUALITY CONTROL, AUDITING, ASSURANCE AND RELATED SERVICES

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¹ An exposure draft containing the proposed “Terms of Reference,” a revised “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services” and Operations Policy No 1, “Bold Type Lettering,” was issued by the IAASB in November 2002. The final Preface will be issued in 2003 and will be available on the IAASB website at <http://www.iaasb.org>.

Introduction

1. This preface to the International Standards on Quality Control, Auditing, Assurance, and Related Services is issued to facilitate understanding of the objectives and operating procedures of the International Auditing and Assurance Standards Board (IAASB) and the scope and authority of the pronouncements it issues.
2. The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is “the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide services of consistently high quality in the public interest.” In pursuing this mission, the IFAC Board has established the IAASB to develop and issue, on its behalf, standards and statements on auditing, assurance and related services, and quality control standards for use around the world.
3. The IAASB’s pronouncements govern assurance and related services that are conducted in accordance with International Standards. They do not override the local laws or regulations that govern the audit of historic financial statements or assurance engagements on other information in a particular country required to be followed in accordance with that country’s national standards. In the event that local laws or regulations differ from, or conflict with, the IAASB’s Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the IAASB’s pronouncements. In these circumstances, member bodies should comply with the obligations of membership set forth in IFAC’s Constitution as regards the IAASB’s pronouncements.²

The International Auditing and Assurance Standards Board

4. The IAASB is a standing committee of IFAC.
5. The members of the IAASB are appointed by the IFAC Board to serve on the IAASB. The IAASB comprises eighteen members, ten of whom are put forward by member bodies of IFAC, five of whom are put forward by the Forum of Firms, and three public members who may be members of IFAC member bodies but shall not be members in public practice. Candidates for appointment as public members may be put forward by any individual or organization for consideration by IFAC’s Nominating Committee. IAASB members are expected to act in the common interest of the public at large and the worldwide accountancy profession. This could result in their taking a position on a matter that is not in accordance with current practice in their

² The IFAC constitution states that “Member bodies shall ... support the work of IFAC by bringing to the notice of their members every pronouncement developed by IFAC and by using their best endeavors:

- (i) to work towards implementation, when and to the extent possible under local circumstances, of those pronouncements, and
- (ii) specifically to incorporate in their national auditing standards the principles on which are based International Standards on Auditing developed by IFAC...”

country or not in accordance with the position taken by those who put them forward for membership of the IAASB. Members who absent themselves from two meetings in any twelve month period may be required to resign from the IAASB.

6. The IAASB may appoint task forces to assist it in the development of materials. These task forces may include individuals who are not members of the IAASB and information may be sought from other organizations so as to obtain a broad spectrum of views.
7. IAASB meetings to discuss the development of Standards, guidance or other papers are open to the public. Agenda papers are published on the IAASB web site.

The Authority Attaching to Standards issued by the International Auditing and Assurance Standards Board

8. International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements dealing with information other than historic financial information.
9. International Standards on Auditing (ISAs) are to be applied in the audit or review of historic financial information.
10. International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information, and other non-assurance services.
11. ISAEs, ISAs and ISRSs are collectively referred to as the IAASB's Engagement Standards.
12. International Standards on Quality Control (ISQCs) are to be applied by those providing services falling under the IAASB's Engagement Standards.
13. The IAASB's Standards contain basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provide guidance for their application. It is therefore necessary to consider the whole text of a Standard to understand and apply the basic principles and essential procedures. This includes the explanatory and other material contained in the Standard, not just the text that is black lettered.
14. The nature of Standards issued by the IAASB requires professional accountants to exercise professional judgment in applying them. In extremely rare circumstances, a professional accountant may judge it necessary to depart from a requirement of an Engagement Standard to achieve more effectively the objective of the engagement. When such a situation arises, the professional accountant should be prepared to justify the departure.

15. Any limitation of the applicability of a specific Standard is made clear in the introductory paragraphs to that Standard.
16. In circumstances where specific Standards or guidance contained in a Standard are not applicable in a public sector environment, or when additional guidance is appropriate in such an environment, IFAC's Public Sector Committee so states in a Public Sector Perspective (PSP). When no PSP is added, the Standard is to be applied to engagements in the public sector.

The Authority Attaching to Practice Statements issued by the International Auditing and Assurance Standards Board

17. International Assurance Engagement Practice Statements (IAEPSs) are issued to provide practical assistance to professional accountants in implementing ISAEs and to promote good practice.
18. International Auditing Practice Statements (IAPs) are issued to provide practical assistance to professional accountants in implementing ISAs and to promote good practice.
19. Professional accountants should be aware of and consider practice statements applicable to the engagement. A professional accountant who does not apply the guidance included in an applicable practice statement should be prepared to explain how the requirements in the Standards addressed by the practice statement have been complied with.

Discussion Papers

20. Discussion Papers are issued to promote discussion or debate on auditing and assurance issues affecting the accounting profession, present findings, or describe matters of interest relating to auditing and assurance issues affecting the accounting profession. They do not establish any requirements to be followed in audits or other assurance engagements.

Working Procedures

Standards and Statements

21. For Standards and Statements, project proposals are developed and approved by the IAASB. As part of this process, input is sought, where practicable, from the Consultative Advisory Group, national standard setters and others. After approval, the IAASB's working procedure is to select subjects for detailed study by a task force established for that purpose. The task force will ordinarily be chaired by a member of the IAASB and may contain members who are not members of the IAASB. The task force has the initial responsibility for the preparation and drafting of Standards and Statements. The task force develops its positions using any available resources. This may include commissioning research, consulting with practitioners, regulators and other interested parties, as well as reviewing professional pronouncements

issued by IFAC member bodies and other parties. The task force prepares an exposure draft for the IAASB to review and debate. When approved, the exposure draft is placed on the IAASB's web site and is widely distributed for comment by member bodies of IFAC, organizations that have an interest in auditing and assurance standards and the general public. Adequate time is allowed for each exposure draft to be considered by the persons and organizations to whom it is sent for comment and the exposure period will ordinarily be no shorter than 90 days. The IAASB will ordinarily expose a Practice Statement for comment unless it decides that there are particular circumstances justifying non-exposure.

22. The comments and suggestions received as a result of this exposure are considered and the exposure draft is revised as appropriate. When the revised draft is approved, it is issued as a definitive Standard or Practice Statement. If the changes made after exposure are substantial, the IAASB will consider the need to reexpose the document for comment. The IAASB will set an effective date for the application of its Standards; Practice Statements will be effective from the date they are issued.

Other Pronouncements

23. For Discussion Papers, the IAASB Chair will appoint a review group of 4 IAASB members to consider whether a draft paper has sufficient merit to be added to the IAASB's assurance and auditing literature. The draft paper may come from any source and the IAASB need not have specifically commissioned it. If the review group believes that the paper has sufficient merit it recommends to the IAASB that the paper be issued and added to its literature. If the IAASB approves the paper, it is issued as a discussion paper.

Voting

24. The affirmative votes of at least two thirds of the members present at a meeting in person or by proxy or by simultaneous telecommunications link, but not less than twelve, is required to approve exposure drafts, Standards and Statements. Discussion Papers require the approval of a majority of the members so present. Dissenting opinions will not be included in the exposure drafts or pronouncements issued by the Board but will be included in the minutes of the meeting at the request of the dissenting member or members.
25. Each member of the IAASB has the right to one vote. A member has the right to appoint a proxy in writing. The proxy may be the member's technical adviser or another IAASB member.

Language

26. The approved text of an exposure draft, Standard, Practice Statement or Discussion Paper is that published by IFAC in the English language.

GLOSSARY OF TERMS AT DECEMBER 2002

Accounting estimate—An accounting estimate is an approximation of the amount of an item in the absence of a precise means of measurement.

Accounting system—An accounting system is the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.

Adverse opinion—(see Modified auditor's report)

Agreed-upon procedures engagement—In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures may misinterpret the results.

Analytical procedures—Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predictable amounts.

Annual report—An entity ordinarily issues on an annual basis a document which includes its financial statements together with the audit report thereon. This document is frequently referred to as the "annual report."

Anomalous error—(see Audit sampling)

Application controls in computer information systems—The specific controls over the relevant accounting applications maintained by the computer. The purpose of application controls is to establish specific control procedures over the accounting applications in order to provide reasonable assurance that all transactions are authorized and recorded, and are processed completely, accurately and on a timely basis.

Appropriateness—Appropriateness is the measure of the quality of audit evidence and its relevance to a particular assertion and its reliability.

Assertions—Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements. (see Financial statements assertions)

Assistants—Assistants are personnel involved in an individual audit other than the auditor.

Assurance—(see Reasonable assurance)

Attendance—Attendance consists of being present during all or part of a process being performed by others; for example, attending physical inventory taking will enable the

auditor to inspect inventory, to observe compliance of management's procedures to count quantities and record such counts and to test-count quantities.

Audit—The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The phrases used to express the auditor's opinion are "give a true and fair view" or "present fairly, in all material respects," which are equivalent terms. A similar objective applies to the audit of financial or other information prepared in accordance with appropriate criteria.

Audit evidence—Audit evidence is the information obtained by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence will comprise source documents and accounting records underlying the financial statements and corroborating information from other sources.

Audit firm—Audit firm is either a firm or entity providing audit services, including where appropriate its partners, or a sole practitioner.

Audit opinion—(see Opinion)

Audit program—An audit program sets out the nature, timing and extent of planned audit procedures required to implement the overall audit plan. The audit program serves as a set of instructions to assistants involved in the audit and as a means to control the proper execution of the work.

Audit risk—Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.

Control risk—Control risk is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material, individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.

Detection risk—Detection risk is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.

Inherent risk—Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

Audit sampling—Audit sampling (sampling) involves the application of audit procedures to less than 100% of items within an account balance or class of transactions such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which

the sample is drawn. Audit sampling can use either a statistical or a non-statistical approach.

Anomalous error—Anomalous error means an error that arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of errors in the population.

Expected error—The error that the auditor expects to be present in the population.

Non-sampling risk—Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, most audit evidence is persuasive rather than conclusive, the auditor might use inappropriate procedures, or the auditor might misinterpret evidence and fail to recognize an error.

Population—Population means the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. A population may be divided into strata, or sub-populations, with each stratum being examined separately. The term population is used to include the term stratum.

Sampling risk—Sampling risk arises from the possibility that the auditor's conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure.

Sampling unit—Sampling unit means the individual items constituting a population, for example checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances, or a monetary unit.

Statistical sampling—Statistical sampling means any approach to sampling that has the following characteristics:

- (a) Random selection of a sample; and
- (b) Use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.

Stratification—Stratification is the process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Tolerable error—Tolerable error means the maximum error in a population that the auditor is willing to accept.

Auditor—The auditor is the person with final responsibility for the audit. This term is also used to refer to an audit firm. (For ease of reference, the term "auditor" is used throughout the ISAs when describing both auditing and related services which may be performed. Such reference is not intended to imply that a person performing related services need necessarily be the auditor of the entity's financial statements.)

Continuing auditor—The continuing auditor is the auditor who audited and reported on the prior period’s financial statements and continues as the auditor for the current period.

External auditor—Where appropriate the terms “external auditor” and “external audit” are used to distinguish the external auditor from an internal auditor and to distinguish the external audit from the activities of internal auditing.

Incoming auditor—The incoming auditor is a current period’s auditor who did not audit the prior period’s financial statements.

Other auditor—The other auditor is an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial statements audited by the principal auditor. Other auditors include affiliated firms, whether using the same name or not, and correspondents, as well as unrelated auditors.

Personnel—Personnel includes all partners and professional staff engaged in the audit practice of the firm.

Predecessor auditor—The auditor who was previously the auditor of an entity and who has been replaced by an incoming auditor.

Principal auditor—The principal auditor is the auditor with responsibility for reporting on the financial statements of an entity when those financial statements include financial information of one or more components audited by another auditor.

Auditor’s association—An auditor is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor’s name in a professional connection.

Comparatives—Comparatives in financial statements, may present amounts (such as financial position, results of operations, cash flows) and appropriate disclosures of an entity for more than one period, depending on the framework. The frameworks and methods of presentation are as follows:

- (a) Corresponding figures where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures; and
- (b) Comparative financial statements where amounts and other disclosures for the preceding period are included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.

Compilation engagement—In a compilation engagement, the accountant is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarize financial information.

Component—Component is a division, branch, subsidiary, joint venture, associated company or other entity whose financial information is included in financial statements audited by the principal auditor.

Comprehensive basis of accounting—A comprehensive basis of accounting comprises a set of criteria used in preparing financial statements which applies to all material items and which has substantial support.

Computation—Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations.

Computer-assisted audit techniques—Applications of auditing procedures using the computer as an audit tool are known as Computer Assisted Audit Techniques (CAATs).

Computer information systems—A computer information systems (CIS) environment exists when a computer of any type or size is involved in the processing by the entity of financial information of significance to the audit, whether that computer is operated by the entity or by a third party.

Confirmation—(see External confirmation)

Continuing auditor—(see Auditor)

Control environment—The control environment comprises the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity.

Control procedures—Control procedures are those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives.

Control risk—(see Audit risk)

Corporate Governance—(see Governance)

Database—A collection of data that is shared and used by a number of different users for different purposes.

Detection risk—(see Audit risk)

Disclaimer of opinion—(see Modified auditor's report)

Documentation—Documentation is the material (working papers) prepared by and for, or obtained and retained by the auditor in connection with the performance of the audit.

Emphasis of matter paragraph(s)—(see Modified auditor's report)

Engagement letter—An engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.

Environmental matters—Environmental matters are defined as:

- (a) Initiatives to prevent, abate, or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources (such initiatives may be required by environmental laws and regulations or by contract, or they may be undertaken voluntarily);
- (b) Consequences of violating environmental laws and regulations;
- (c) Consequences of environmental damage done to others or to natural resources; and
- (d) Consequences of vicarious liability imposed by law (for example, liability for damages caused by previous owners).

Environmental performance report—An environmental performance report is a report, separate from the financial statements, in which an entity provides third parties with qualitative information on the entity's commitments towards the environmental aspects of the business, its policies and targets in that field, its achievement in managing the relationship between its business processes and environmental risk, and quantitative information on its environmental performance.

Environmental risk—In certain circumstances, factors relevant to the assessment of inherent risk for the development of the overall audit plan may include the risk of material misstatement of the financial statements due to environmental matters.

Error—An error is an unintentional mistake in financial statements.

Expected error— (see Audit sampling)

Expert—An expert is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

External audit/auditor—(see Auditor)

External confirmation—External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements.

Fair Value—The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial statements—The balance sheets, income statements or profit and loss accounts, statements of changes in financial position (which may be presented in a variety of ways, for example, as a statement of cash flows or a statement of fund flows), notes and other statements and explanatory material which are identified as being part of the financial statements.

Summarized financial statements—An entity may prepare financial statements summarizing its annual audited financial statements for the purpose of informing user groups interested in the highlights only of the entity's financial performance and position.

Financial statement assertions—Financial statement assertions are assertions by management, explicit or otherwise, that are embodied in the financial statements and can be categorized as follows:

- (a) *Existence*: an asset or a liability exists at a given date;
- (b) *Rights and obligations*: an asset or a liability pertains to the entity at a given date;
- (c) *Occurrence*: a transaction or event took place which pertains to the entity during the period;
- (d) *Completeness*: there are no unrecorded assets, liabilities, transactions or events, or undisclosed items;
- (e) *Valuation*: an asset or liability is recorded at an appropriate carrying value;
- (f) *Measurement*: a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period; and
- (g) *Presentation and disclosure*: an item is disclosed, classified, and described in accordance with the applicable financial reporting framework.

Forecast—A forecast is prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

Fraud—The term “fraud” refers to an intentional act by one or more individuals among management, employees, or third parties, which results in a misrepresentation of financial statements.

General controls in computer information systems—The establishment of a framework of overall control over the computer information systems activities to provide a reasonable level of assurance that the overall objectives of internal control are achieved.

Going concern assumption—Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Governance—The term “governance” describes the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.

Government business enterprises—Government business enterprises are businesses which operate within the public sector ordinarily to meet a political or social interest

objective. They are ordinarily required to operate commercially, that is, to make profits or to recoup, through user charges a substantial proportion of their operating costs.

Incoming auditor—(see Auditor)

Inherent risk—(see Audit risk)

Inquiry—Inquiry consists of seeking information of knowledgeable persons inside or outside the entity.

Inspection—Inspection consists of examining records, documents, or tangible assets.

Interim financial information or statements—Financial information (which may be less than full financial statements as defined above) issued at interim dates (usually half-yearly or quarterly) in respect of a financial period.

Internal auditing—Internal auditing is an appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of the accounting and internal control systems.

Internal control system—An internal control system consists of all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal control system extends beyond these matters which relate directly to the functions of the accounting system.

Knowledge of the business—The auditor's general knowledge of the economy and the industry within which the entity operates and a more particular knowledge of how the entity operates.

Limitation on scope—A limitation on the scope of the auditor's work may sometimes be imposed by the entity (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary). A scope limitation may be imposed by circumstances (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed desirable.

Management—Management comprises officers and others who also perform senior managerial functions. Management includes directors and the audit committee only in those instances when they perform such functions.

Management representations—Representations made by management to the auditor during the course of an audit, either unsolicited or in response to specific inquiries.

Material inconsistency—A material inconsistency exists when other information contradicts information contained in the audited financial statements. A material

inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

Material misstatement of fact—A material misstatement of fact in other information exists when such information, not related to matters appearing in the audited financial statements, is incorrectly stated or presented.

Material weaknesses—The weaknesses in internal control that could have a material effect on the financial statements.

Materiality—Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cutoff point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Misstatement—A mistake in financial information which would arise from errors and fraud.

Modified auditor's report—An auditor's report is considered to be modified if either an emphasis of matter paragraph(s) is added to the report or if the opinion is other than unqualified:

Matters That Do Not Affect the Auditor's Opinion

Emphasis of matter paragraph(s)—An auditor's report may be modified by adding an emphasis of matter paragraph(s) to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph(s) does not affect the auditor's opinion. The auditor may also modify the auditor's report by using an emphasis of matter paragraph(s) to report matters other than those affecting the financial statements.

Matters That Do Affect The Auditor's Opinion

Qualified opinion—A qualified opinion is expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion.

Disclaimer of opinion—A disclaimer of opinion is expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

Adverse opinion—An adverse opinion is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

National practices (auditing)—A set of auditing guidelines not having the authority of standards defined by an authoritative body at a country level and commonly applied by auditors in the conduct of an audit or related services.

National standards (auditing)—A set of auditing standards defined by law or regulations or an authoritative body at a country level, the application of which is mandatory in conducting an audit or related services and which should be complied with in the conduct of an audit or related services.

Noncompliance—The term “noncompliance” is used to refer to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

Non-sampling risk—(see Audit sampling)

Observation—Observation consists of looking at a process or procedure being performed by others, for example, the observation by the auditor of the counting of inventories by the entity’s personnel or the performance of internal control procedures that leave no audit trail.

Opening balances—Opening balances are those account balances which exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions of prior periods and accounting policies applied in the prior period.

Opinion—The auditor’s report contains a clear written expression of opinion on the financial statements as a whole. An unqualified opinion is expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects,) in accordance with the identified financial reporting framework. (See Modified auditor’s report)

Other auditor—(see Auditor)

Personnel—(see Auditor)

Planning—Planning involves developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit.

Population—(see Audit sampling)

Post balance sheet events—(see Subsequent events)

Predecessor auditor—(see Auditor)

Principal auditor—(see Auditor)

Projection—A projection is prospective financial information prepared on the basis of:

- (a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
- (b) A mixture of best-estimate and hypothetical assumptions.

Prospective financial information—Prospective financial information is financial information based on assumptions about events that may occur in the future and possible actions by an entity. Prospective financial information can be in the form of a forecast, a projection or a combination of both. (See Forecast and Projection)

Public sector—The term “public sector” refers to national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises).

Qualified opinion—(see Modified auditor’s report)

Quality controls—The policies and procedures adopted by a firm to provide reasonable assurance that all audits done by the firm are being carried out in accordance with the Objective and General Principles Governing an Audit of Financial Statements, as set out in International Standard on Auditing 220 “Quality Control for Audit Work.”

Reasonable assurance—In an audit engagement, the auditor provides a high, but not absolute, level of assurance, expressed positively in the audit report as reasonable assurance, that the information subject to audit is free of material misstatement.

Related parties—Related parties and related party transaction are defined in International Accounting Standard 24 as:

Related party—Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions.

Related party transaction—A transfer of resources or obligations between related parties, regardless of whether a price is charged.

Related services—Related services comprise reviews, agreed-upon procedures and compilations.

Review engagement—The objective of a review engagement is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor’s attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.

Sampling risk—(see Audit sampling)

Sampling unit—(see Audit sampling)

Scope of an Audit—The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit.

Scope of a Review—The term “scope of a review” refers to the review procedures deemed necessary in the circumstances to achieve the objective of the review.

Scope limitation—(see Limitation on scope)

Segment information—Information in the financial statements regarding distinguishable components or industry and geographical aspects of an entity.

Service organization—A client may use a service organization such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer information systems service organization).

Significance—Significance is related to materiality of the financial statement assertion affected.

Small entity—A small entity is any entity in which:

- (a) There is concentration of ownership and management in a small number of individuals (often a single individual); and
- (b) One or more of the following are also found:
 - (i) Few sources of income;
 - (ii) Unsophisticated record-keeping; and
 - (iii) Limited internal controls together with the potential for management override of controls.

Small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

Special purpose auditor's report—A report issued in connection with the independent audit of financial information other than an auditor's report on financial statements, including:

- (a) Financial statements prepared in accordance with a comprehensive basis of accounting other than International Accounting Standards or national standards;
- (b) Specified accounts, elements of accounts, or items in a financial statement;
- (c) Compliance with contractual agreements; and
- (d) Summarized financial statements.

Statistical sampling—(see Audit sampling)

Stratification—(see Audit sampling)

Subsequent events—International Accounting Standard 10 identifies two types of events both favorable and unfavorable occurring after period end:

- (a) Those that provide further evidence of conditions that existed at period end; and
- (b) Those that are indicative of conditions that arose subsequent to period end.

Substantive procedures—Substantive procedures are tests performed to obtain audit evidence to detect material misstatements in the financial statements, and are of two types:

- (a) Tests of details of transactions and balances; and
- (b) Analytical procedures.

Sufficiency—Sufficiency is the measure of the quantity of audit evidence.

Summarized financial statements—(see Financial statements)

Supreme Audit Institution—The public body of a State which, however designated, constituted or organized, exercises by virtue of law, the highest public auditing function of that State.

Tests of control—Tests of control are performed to obtain audit evidence about the effectiveness of the:

- (a) Design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and
- (b) Operation of the internal controls throughout the period.

Tolerable error—(see Audit sampling)

Uncertainty—An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

Unqualified opinion—(see Opinion)

Walk-through test—A walk-through test involves tracing a few transactions through the accounting system.

Working papers—Working papers are a record of the auditor's planning; nature, timing and extent of the auditing procedures performed; and results of such procedures and the conclusions drawn from the evidence obtained. Working papers may be in the form of data stored on paper, film, electronic media or other media.

GLOSSARY OF IT TERMS

When the IAPC exposed for comments its revisions to its IT Practice Statements, it indicated that the IAPC was in the process of revising its guidance on IT systems. Many commentators on the exposure draft suggested that some terms that the exposure drafts used and defined were general terms and should be removed from the particular IAPs and placed in a separate glossary. Accordingly, the following terms will be defined in the IAPC's subsequent guidance. However, until that guidance is published they are being shown here in a separate glossary.

Access controls—Procedures designed to restrict access to on-line terminal devices, programs and data. Access controls consist of “user authentication” and “user authorization.” “User authentication” typically attempts to identify a user through unique logon identifications, passwords, access cards or biometric data. “User authorization” consists of access rules to determine the computer resources each user may access. Specifically, such procedures are designed to prevent or detect:

- (a) Unauthorized access to on-line terminal devices, programs and data;
- (b) Entry of unauthorized transactions;
- (c) Unauthorized changes to data files;
- (d) The use of computer programs by unauthorized personnel; and
- (e) The use of computer programs that have not been authorized.

Encryption (cryptography)—The process of transforming programs and information into a form that cannot be understood without access to specific decoding algorithms (cryptographic keys). For example, the confidential personal data in a payroll system may be encrypted against unauthorized disclosure or modification. Encryption can provide an effective control for protecting confidential or sensitive programs and information from unauthorized access or modification. However, effective security depends upon proper controls over access to the cryptographic keys.

Electronic Data Interchange (EDI)—The electronic transmission of documents between organizations in a machine-readable form.

Firewall—A combination of hardware and software that protects a WAN, LAN or PC from unauthorized access through the Internet and from the introduction of unauthorized or harmful software, data or other material in electronic form.

IT environment—The policies and procedures that the entity implements and the IT infrastructure (hardware, operating systems, *etc*) and application software that it uses to support business operations and achieve business strategies.

Local Area Network (LAN)—A communications network that serves users within a confined geographical area. LANs were developed to facilitate the exchange and sharing of resources within an organization, including data, software, storage, printers and telecommunications equipment. They allow for decentralized computing. The basic

components of a LAN are transmission media and software, user terminals and shared peripherals.

PCs or personal computers (also referred to as microcomputers)—Economical yet powerful self-contained general purpose computers consisting typically of a monitor (visual display unit), a case containing the computer electronics and a keyboard (and mouse). These features may be combined in portable computers [laptops]. Programs and data may be stored internally on a hard disk or on removable storage media such as CDs or floppy disks. PCs may be connected to on-line networks, printers and other devices such as scanners and modems.

Programming controls—Procedures designed to prevent or detect improper changes to computer programs that are accessed through on-line terminal devices. Access may be restricted by controls such as the use of separate operational and program development libraries and the use of specialized program library software. It is important for on-line changes to programs to be adequately documented, controlled and monitored.

Transaction logs—Reports that are designed to create an audit trail for each on-line transaction. Such reports often document the source of a transaction (terminal, time and user) as well as the transaction's details.

Wide area network (WAN)—A communications network that transmits information across an expanded area such as between plant sites, cities and nations. WANs allow for on-line access to applications from remote terminals. Several LANs can be interconnected in a WAN.

INTERNATIONAL STANDARD ON ASSURANCE ENGAGEMENTS 100

ASSURANCE ENGAGEMENTS

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Preface

This International Standard on Assurance Engagements (ISAE) provides an overall framework for assurance engagements intended to provide either a high or moderate level of assurance.

It establishes the basic principles and essential procedures for professional accountants in public practice for the performance of engagements intended to provide a high level of assurance. This ISAE does not, however, provide basic principles and essential procedures for engagements intended to provide a moderate level of assurance. IAPC is developing further guidance on such engagements.

This document is being released with an accompanying report. The report describes and explains the changes made from the exposure draft and contains a discussion of the comments received, a description of the issues raised and how the IAPC responded to them, including the research planned to resolve the outstanding issue related to the moderate level of assurance.

Introduction

1. This International Standard on Assurance Engagements has three purposes:
 - (a) To describe the objectives and elements of assurance engagements intended to provide either a high or moderate level of assurance (paragraphs 4-30);
 - (b) To establish standards for and provide guidance to professional accountants in public practice for the performance of engagements intended to provide a high level of assurance (paragraphs 31-74); and
 - (c) To act as a framework for the development by the IAPC of specific standards for particular types of assurance engagements.
2. When a professional accountant is engaged to perform an assurance engagement for which specific standards exist, those standards apply: if no specific standards exist for an assurance engagement, this document applies. Where a professional accountant in public practice performs an engagement intended to provide a high level of assurance for which no specific standards exist, the standards and principles set out in paragraphs 31-74 are to be followed.
3. This Standard does not supersede the existing International Standards on Auditing (ISAs). For example, it does not apply to an audit or review of financial statements.

OBJECTIVE AND ELEMENTS OF AN ASSURANCE ENGAGEMENT

Objective of an Assurance Engagement

4. The objective of an assurance engagement is for a professional accountant to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a level of assurance about that subject matter. Assurance engagements performed by professional accountants are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria, thereby improving the likelihood that the information will meet the needs of an intended user. In this regard, the level of assurance provided by the professional accountant's conclusion conveys the degree of confidence that the intended user may place in the credibility of the subject matter.
5. There is a broad range of assurance engagements, which includes any combination of the following.
 - Engagements to report on a broad range of subject matters covering financial and non-financial information.

- Engagements intended to provide high or moderate levels of assurance.
 - Attest and direct reporting engagements.
 - Engagements to report internally and externally.
 - Engagements in the private and public sector.
6. Not all engagements performed by professional accountants are assurance engagements. This does not mean that professional accountants do not undertake such engagements, only that these engagements are not covered by this Standard. Other engagements frequently performed by professional accountants that are not assurance engagements include the following.
- Agreed-upon procedures.
 - Compilation of financial or other information.
 - Preparation of tax returns where no conclusion is expressed, and tax consulting.
 - Management consulting.
 - Other advisory services.
7. An agreed-upon procedures engagement, in which the party engaging the professional accountant or the intended user determines the procedures to be performed and the professional accountant provides a report of factual findings as a result of undertaking those procedures, is not an assurance engagement. While the intended user of the report may derive some assurance from the report of factual findings, the engagement is not intended to provide, nor does the professional accountant express, a conclusion that provides a level of assurance. Rather, the intended user assesses the procedures and findings and draws his or her own conclusions. However, a professional accountant may undertake an engagement that is similar to an agreed-upon procedures engagement but which does result in the expression of a conclusion that provides a level of assurance. Where, in the judgment of the professional accountant, the procedures agreed to be performed are appropriate to support the expression of a conclusion that provides a level of assurance on the subject matter, and the professional accountant intends to do so, then such an engagement becomes an assurance engagement governed by this standard.

Elements of an Assurance Engagement

8. Whether a particular engagement is an assurance engagement will depend upon whether it exhibits all the following elements.
- (a) A three party relationship involving:
- (i) A professional accountant;
 - (ii) A responsible party; and
 - (iii) An intended user;

- (b) A subject matter;
- (c) Suitable criteria;
- (d) An engagement process; and
- (e) A conclusion.

Three Party Relationship

9. Assurance engagements involve three separate parties: a professional accountant, a responsible party and an intended user. The professional accountant provides assurance to the intended user about a subject matter that is the responsibility of another party.
10. The responsible party and the intended user will often be from separate organizations but need not be. A responsible party and an intended user may both be within the same organization, for example, a governing body may seek assurance about information provided by a component of that organization. The relationship between the responsible party and the intended user needs to be viewed within the context of a specific engagement and may supersede more traditionally defined responsibility lines.

Professional Accountant

11. The IFAC *Code of Ethics for Professional Accountants* (the Code) defines professional accountants as those persons who are members of an IFAC member body, whether they be in public practice (as a sole practitioner, partnership or corporate body), industry, commerce, the public sector or education. The term “professional accountant” in this Standard includes the term “auditor” but also recognizes that assurance engagements deal with a broader range of subject matter and reporting arrangements than the issue of an audit opinion by external auditors on financial statements.
12. The fundamental principles that the professional accountant has to observe are:
 - (a) Integrity;
 - (b) Objectivity;
 - (c) Professional competence and due care;
 - (d) Confidentiality;
 - (e) Professional behavior; and
 - (f) Application of technical standards.
13. The requirement relating to the “objectivity” principle is of particular importance in an assurance engagement in ensuring that the conclusion of the professional accountant has value to the intended user. The intended user needs to have confidence that the professional accountant has no interest that creates an unacceptable risk of bias with respect to the subject matter.

14. Professional accountants in public practice also have to observe the requirements of Part B of the Code, which includes a requirement to be independent when conducting an assurance engagement.
15. Professional accountants may be requested to perform an assurance engagement on a wide range of subject matters. However, professional accountants will not agree to perform an assurance engagement which they are not competent to carry out, unless competent advice and assistance is obtained so as to enable them to satisfactorily perform such services. If a professional accountant does not have the competence to perform a specific part of the assurance engagement, technical advice will be sought from experts.

Responsible Party

16. The responsible party is the person or persons, either as individuals or representatives of an entity, responsible for the subject matter. For example, management is responsible for the preparation of financial statements or the implementation and operation of internal control. The responsible party may or may not be the party who engages the professional accountant. The professional accountant may be engaged by management or by other parties.

Intended User

17. The intended user is the person or class of persons for whom the professional accountant prepares the report for a specific use or purpose. The intended user may be established by agreement between the professional accountant and the responsible party or those engaging or employing the professional accountant. In some circumstances the intended user may be established by law. The responsible party may also be one of the intended users. Often the intended user will be the addressee of the professional accountant's report but there may be circumstances where there will be intended users other than the addressee. There may also be situations where the responsible party will be the addressee, but will make the report available to the intended users.
18. Some intended users (for example, bankers and regulators) may impose a requirement on, or may request the responsible party to arrange for an assurance engagement to be carried out on a particular subject matter. However, other intended users may have no direct involvement in defining the arrangements for an assurance engagement.
19. In circumstances where the engagement is for a special purpose, the professional accountant may consider restricting the report to specific intended users, and indicating in a restriction in the report that others not identified as users may not rely on it.

Subject Matter

20. The subject matter of an assurance engagement may take many forms, such as the following:

- Data (for example, historical or prospective financial information, statistical information, performance indicators).
- Systems and processes (for example, internal controls).
- Behavior (for example, corporate governance, compliance with regulation, human resource practices).

The subject matter may be presented as at a point in time or covering a period of time.

21. The subject matter of an assurance engagement is to be identifiable, capable of consistent evaluation or measurement against suitable criteria and in a form that can be subjected to procedures for gathering evidence to support that evaluation or measurement.

Criteria

22. Criteria are the standards or benchmarks used to evaluate or measure the subject matter of an assurance engagement. Criteria are important in the reporting of a conclusion by a professional accountant as they establish and inform the intended user of the basis against which the subject matter has been evaluated or measured in forming the conclusion. Without this frame of reference any conclusion is open to individual interpretation and misunderstanding. Criteria in an assurance engagement need to be suitable to enable reasonably consistent evaluation or measurement of the subject matter within the context of professional judgment. Suitable criteria are context-sensitive, that is, relevant to the engagement circumstances.
23. For example, in the preparation of financial statements the criteria may be International Accounting Standards or International Public Sector Accounting Standards, which are intended to provide a range of users with relevant and consistent information about an entity's financial position, results of operations and cash flows. In an audit of financial statements, the auditor provides assurance as to whether the financial statements give a true and fair view of (or present fairly, in all material respects), an entity's financial position, results of operations and cash flows by using the accounting framework to evaluate the preparation and presentation of the subject matter. When reporting on the way in which an entity is organized or managed, or the extent to which its objectives have been achieved, generally accepted criteria for a particular industry may be used. When reporting on internal control, the criteria may be an established internal control framework or stated internal control criteria. When reporting on compliance, the criteria may be the applicable law, regulation or contract. Criteria may also be developed for specific users, for example, a party to a contract who wants assurance that other parties to the same contract are complying with the contract terms.

Engagement Process

24. The engagement process for an assurance engagement is a systematic methodology requiring a specialized knowledge and skill base, and techniques for evidence gathering and evaluation and measurement to support a conclusion, irrespective of the nature of the engagement subject matter. The process involves the professional accountant and those who engage the professional accountant agreeing to the terms of the engagement. Within that context, the professional accountant considers materiality and the relevant components of engagement risk when planning and conducting the engagement. An assurance engagement involves the professional accountant planning and conducting the engagement to obtain sufficient appropriate evidence and applying professional judgment in order to express a conclusion.

Conclusion

25. The professional accountant expresses a conclusion that provides a level of assurance as to whether the subject matter conforms in all material respects with the identified suitable criteria.
26. In an attest engagement, the professional accountant's conclusion relates to an assertion by the responsible party. The assertion is the responsible party's conclusion about the subject matter based on identified suitable criteria. The professional accountant can either express a conclusion about the assertion by the responsible party, or provide a conclusion about the subject matter in a form similar to the assertion made by the responsible party. In the latter case the assurance is provided because the professional accountant's conclusion on the subject matter supports the assertion by the responsible party.
27. In a direct reporting engagement, the professional accountant expresses a conclusion on the subject matter based on suitable criteria, regardless of whether the responsible party has made a written assertion on the subject matter.
28. The professional accountant's conclusion provides a level of assurance about the subject matter. In theory, it is possible to provide an infinite range of assurance from a very low level of assurance to an absolute level of assurance. In practice, it is not ordinarily practicable to design an engagement to provide such fine graduations of assurance or to communicate the level of assurance in a clear and unambiguous manner. In addition, absolute assurance is generally not attainable as a result of such factors as the use of selective testing, the inherent limitations of control systems, the fact that much of the evidence available to the professional accountant is persuasive rather than conclusive, and the use of judgment in gathering evidence and drawing conclusions based on that evidence. Therefore, professional accountants ordinarily undertake engagements to provide one of only two distinct levels: a high level and a moderate level. These engagements are affected by various elements, for example, the degree of precision associated with the subject matter, the nature

timing and extent of procedures, and the sufficiency and appropriateness of the evidence available to support a conclusion.

29. The expression “high level of assurance” refers to the professional accountant having obtained sufficient appropriate evidence to conclude that the subject matter conforms in all material respects with identified suitable criteria. In rare circumstances, the professional accountant may be able to provide absolute assurance, for example, where the evidence available is conclusive and reliable because the subject matter is determinate, the criteria definitive and the process applied comprehensive. However, because of the limitations of the engagement process, a high level of assurance is ordinarily less than absolute. The professional accountant designs the engagement to reduce to a low level the risk of an inappropriate conclusion that the subject matter conforms in all material respects with identified suitable criteria.
30. The expression “moderate level of assurance” refers to the professional accountant having obtained sufficient appropriate evidence to be satisfied that the subject matter is plausible in the circumstances. The professional accountant designs the engagement to reduce to a moderate level the risk of an inappropriate conclusion. The professional accountant designs the report to convey a moderate level of assurance regarding the conformity of the subject matter with identified suitable criteria.

The following section contains the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material for high level assurance engagements performed by professional accountants in public practice where no specific standards exist. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the Standard, including explanatory and other material contained therein, not just that text which is black lettered.

In exceptional circumstances, a professional accountant may judge it necessary to depart from this Standard in order to more effectively achieve the objective of the engagement. When such a situation arises, the professional accountant should be prepared to justify the departure.

This Standard need only be applied to material aspects of the subject matter.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of a standard. Where no PSP is added, the standard is applicable in all material respects to the public sector.

HIGH-LEVEL ASSURANCE ENGAGEMENTS

Scope of Standard

31. **The objective of a high level assurance engagement is for a professional accountant in public practice to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a high level of assurance about that subject matter.** The term “practitioner” is used hereafter to refer to a professional accountant in public practice.
32. The term “high level assurance engagement” is used to describe any assurance engagement intended to provide a high, but not absolute, level of assurance. The practitioner designs the engagement process so that the risk of expressing an inappropriate conclusion that the subject matter conforms in all material respects with suitable criteria, is reduced to a low level. The practitioner obtains sufficient appropriate evidence through procedures such as inspection, observation, inquiry, confirmation, computation and analysis.

Ethical Requirements

33. **The practitioner should comply with the requirements of the IFAC *Code of Ethics for Professional Accountants* (the Code).**
34. **A practitioner who performs an assurance engagement should be independent.** Section 8 of the Code indicates some of the situations which, because of the actual or apparent lack of independence, would give a reasonable observer grounds for doubting the independence of a practitioner.

Accepting the Engagement

35. **The practitioner should accept an engagement only if the subject matter is the responsibility of another party.** Acknowledgement by the responsible party provides evidence that the appropriate relationship exists and also establishes a basis for a common understanding of the responsibility of each party. Obtaining this acknowledgement in writing provides the most appropriate form of documentation of the responsible party’s acknowledgement, but, recognizing the broad range of assurance engagements, this is not always practical. There may be other sources of evidence that indicate responsibility for the subject matter; for example, it may be clearly established in legislation, or contract. When the practitioner has other evidence that the responsibility exists, acknowledgement of responsibility for the subject matter may be obtained at other points in the engagement such as through discussions on the criteria or the level of assurance.
36. **The practitioner should accept the engagement only if the subject matter is identifiable and in a form that can be subjected to evidence gathering procedures, and the practitioner is not aware of any reason for believing that a conclusion expressing a high level of assurance about the subject**

matter based on suitable criteria cannot be expressed. The practitioner may accept the engagement only if, as a result of initial discussions with one or more of the parties associated with the engagement, and on the basis of a preliminary knowledge of the engagement circumstances, nothing comes to the attention of the practitioner to indicate that the requirements of this Standard will not be satisfied. The practitioner also needs to have a reasonable basis for believing that a conclusion with a high level of assurance concerning the subject matter can be provided and that the conclusion can be meaningful to the intended user of the report of the practitioner.

37. **The practitioner should be satisfied that those performing the engagement possess collectively the necessary professional expertise to perform the engagement.** Some subject matters may require specialist skills and knowledge beyond those practitioners ordinarily possess. In such cases the practitioner ensures that those persons carrying out the engagement as a team possess the requisite skills and knowledge.

Agreeing the Terms of the Engagement

38. **The practitioner should agree on the terms of the assurance engagement with the party who engages the practitioner.** As a means of reducing uncertainty, it is recommended that the agreed terms be recorded in an engagement letter or other suitable form of contract. In some cases the engagement objective, subject matter and time period are prescribed by a party or parties other than the one that appoints the practitioner, for example, by legislation. Where the assurance engagement mandate is legislated, acknowledgement of the legislative mandate meets this requirement.
39. A practitioner who, before the completion of the engagement, is requested to change the engagement from one that provides a high level of assurance to a different engagement, considers the appropriateness of doing so, and cannot agree to a change where there is no reasonable justification for the change.

Quality Control

40. **The practitioner should implement quality control policies and procedures designed to ensure that all assurance engagements are conducted in accordance with applicable standards issued by the International Federation of Accountants.** Quality control policies and procedures apply at two levels, and relate to the overall policies and procedures for all assurance engagements and also to the direction, supervision and review of work delegated to personnel involved in a specific assurance engagement. ISA 220 “Quality Control for Audit Work” sets out the current applicable standards.

Planning and Conduct

41. **The practitioner should plan and conduct the assurance engagement in an effective manner to meet the objective of the engagement.** Planning consists of developing a general strategy and a detailed approach to the assurance

engagement, and assists the proper assignment and supervision of work. The following are examples of the main matters that need to be considered.

- The engagement objective.
- The criteria to be used.
- The engagement process and possible sources of evidence.
- Preliminary judgments about materiality and engagement risk.
- Personnel and expertise requirements, including the nature and extent of the involvement of the experts.

Planning and supervision are continuous throughout the engagement, and plans may need to be changed as the engagement progresses.

42. **The practitioner should plan and conduct an assurance service engagement with an attitude of professional skepticism.** The practitioner neither assumes that the responsible party is dishonest nor assumes unquestioned honesty. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of evidence. Without an attitude of professional skepticism, the practitioner may not be alert to circumstances that lead to a suspicion, and may draw inappropriate conclusions from the evidence obtained.
43. **The practitioner should have or obtain knowledge of the engagement circumstances sufficient to identify and understand the events, transactions and practices that may have a significant effect on the subject matter and engagement.** Such knowledge is used by the practitioner in assessing the suitability of the criteria, engagement risk and in determining the nature, timing and extent of engagement procedures.
44. **The practitioner should assess whether the criteria are suitable to evaluate the subject matter.** Criteria can be either *established* or *specifically developed*. Established criteria are those embodied in laws or regulations, or issued by recognized bodies of experts that follow due process. Specifically developed criteria are those identified for the purpose of the engagement and which are consistent with the engagement objective. The source of the criteria will affect the amount of work the practitioner will need to carry out in order to assess suitability for a particular engagement. In addition, those engaging the practitioner and the practitioner agree on the criteria. The practitioner may also discuss the criteria to be used with the responsible party or the intended user.
45. The decision as to whether the criteria are suitable involves considering whether the subject matter is capable of reasonably consistent evaluation against or measurement using such criteria. The characteristics for determining whether criteria are suitable are as follows:
 - (a) Relevance: relevant criteria contribute to conclusions that meet the objectives of the engagement, and have value in terms of improving the

quality of the subject matter, or its content, so as to assist decision making by intended users;

- (b) Reliability: reliable criteria result in reasonably consistent evaluation or measurement and, where relevant, presentation of the subject matter and conclusions when used in similar circumstances by similarly qualified professional accountants;
 - (c) Neutrality: neutral criteria are free from bias. Criteria are not neutral if they cause the practitioner's conclusion to mislead report users;
 - (d) Understandability: understandable criteria are clear and comprehensive and are not subject to significantly different interpretation; and
 - (e) Completeness: complete criteria exist when all the criteria that could affect the conclusions are identified or developed, and used.
46. The assessment of whether criteria are suitable involves weighing the relative importance of each characteristic and is a matter of judgment in light of the specific objective of the engagement. Irrespective of whether the subject matter is quantitative or qualitative, the criteria are to be suitable. In applying the guidance in paragraph 45, it is recognized that while suitable criteria are to possess each of the characteristics, the evidence available to support some of those characteristics for a particular subject matter will be less conclusive. If any of the characteristics are not met, the criteria are unsuitable. In emerging types of assurance engagements it is less likely that there will be established criteria, and therefore criteria will need to be specifically developed.
47. The practitioner ordinarily concludes that established criteria are suitable when the criteria are consistent with the engagement objective, unless an identifiable limited group of users has agreed to other criteria. In such cases, the practitioner's report indicates that the report is intended only for the use of the identified users. For example, International Accounting Standards are established criteria for the preparation and presentation of financial statements, but a particular user may specify an alternative basis of accounting that meets the user's specific information needs. The practitioner needs to be satisfied that specifically developed criteria do not result in a report that is misleading to intended users. The practitioner attempts to obtain from the intended users, those engaging the practitioner, or the responsible party, acknowledgement that specifically developed criteria are sufficient for the intended users' purposes. When such acknowledgement cannot be obtained, the practitioner considers the effect of this on the nature and extent of work required to be satisfied as to the suitability of the criteria and on the information provided about the criteria in the report of the practitioner.
48. **The practitioner should consider materiality and engagement risk when planning and conducting an assurance engagement in order to reduce the risk of expressing an inappropriate conclusion that the subject matter conforms in all material respects with suitable criteria.** When considering materiality, the practitioner needs to understand and assess what factors might

influence the decisions of the intended users. Materiality can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the subject matter and the expressed interests of intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the practitioner's judgment.

49. Engagement risk¹ is the risk that the practitioner will express an inappropriate conclusion that the subject matter conforms in all material respects with suitable criteria. The practitioner plans and performs the engagement so as to reduce to an acceptable level the risk of expressing an inappropriate conclusion. In general, engagement risk can be represented by the following components:
 - (a) Inherent risk: the risks associated with the nature of the subject matter;
 - (b) Control risk: the risk that the responsible party's controls over the subject matter will not prevent, or detect and correct on a timely basis, matters that could affect the subject matter; and
 - (c) Detection risk: the risk that the practitioner's procedures will not detect material matters that could affect the subject matter.
50. While considered by the practitioner in all engagements, not all components of the engagement risk model will be significant for all assurance engagements. The extent to which the practitioner considers the relevant components of engagement risk will be affected by the engagement circumstances, for example the nature of the subject matter.
51. Engagement risk is influenced by the risks associated with:
 - (a) The nature and form of the subject matter;
 - (b) The nature and form of the criteria applied to the subject matter;
 - (c) The nature and extent of the process used to collect and evaluate evidence; and
 - (d) The sufficiency and appropriateness of the evidence likely to be available.

Evidence

52. **The practitioner should obtain sufficient appropriate evidence on which to base the conclusion.**
53. The concepts of sufficiency and appropriateness of evidence are interrelated, and include considering the reliability of evidence. Sufficiency is the measure of the quantity of evidence obtained and appropriateness is the measure of its

¹ In addition to engagement risk, the professional accountant is exposed to a business risk through loss or injury from litigation, adverse publicity, or other event arising in connection with a subject matter reported on. Business risk is not part of engagement risk and does not affect the application of this International Standard on Assurance Engagements.

quality, including its relevance to the subject matter. The decision as to whether sufficient evidence has been obtained will be influenced by its quality. The quality of evidence available to the practitioner will be affected by the nature of the subject matter and the quality of the criteria, and also by the nature and extent of the procedures applied by the practitioner. A determination as to the sufficiency and appropriateness of evidence is a matter of professional judgment.

54. The practitioner collects and evaluates evidence to evaluate whether the subject matter is in conformity with the identified criteria. The reliability of evidence is influenced by its source: internal or external, and by its nature: visual, documentary or oral. While the reliability of evidence is dependent on individual circumstances, the following generalizations will help in assessing the reliability of evidence:
 - (a) Evidence from external sources is more reliable than that generated internally;
 - (b) Evidence generated internally is more reliable when subject to appropriate controls within the entity;
 - (c) Evidence obtained directly by the practitioner is more likely to be reliable than that obtained from the entity; and
 - (d) Evidence in the form of documents and written representation is more likely to be reliable than oral representations.
55. Evidence is more persuasive when items of evidence from different sources or of a different nature are consistent. In these circumstances, the practitioner may obtain a cumulative degree of confidence higher than that obtained from items of evidence considered individually. Conversely, when evidence obtained from one source is inconsistent with that obtained from another, the practitioner determines what additional procedures are necessary to resolve the inconsistency.
56. In terms of obtaining sufficient appropriate evidence, it is generally more difficult to provide assurance on subject matter covering a period of time than subject matter covering a point in time. In addition, conclusions provided on processes are generally limited to the period covered by the engagement and do not extend to providing any assurance that the process will continue in the future.

Documentation

57. **The practitioner should document matters that are important in providing evidence to support the conclusion expressed in the practitioner's report, and in providing evidence that the assurance engagement was performed in accordance with applicable standards.**
58. Documentation includes a record of the practitioner's reasoning on all significant matters that require the exercise of judgment, together with the

practitioner's conclusion thereon. In areas involving difficult questions of principle or judgment, the documentation will include the relevant facts that were known by the practitioner at the time the conclusion was reached.

59. The extent of documentation is a matter of professional judgment since it is neither necessary nor practical to document every matter the practitioner considers. In assessing the extent of documentation to be prepared and retained, it may be useful for the practitioner to consider what is necessary to provide another professional accountant who has no previous experience with the engagement with an understanding of the work performed and the basis of the principal decisions taken, but not the detailed aspects of the engagement. However, even then, that other professional accountant may only be able to obtain an understanding of detailed aspects of the engagement by discussing them with the practitioner who prepared the documentation.

Subsequent Events

60. **The practitioner should consider the effect of subsequent events up to the date of the practitioner's report. When the practitioner becomes aware of events that materially affect the subject matter and the practitioner's conclusion, the practitioner should consider whether the subject matter reflects those events properly or whether those events are addressed properly in the practitioner's report.** The extent of any consideration of subsequent events depends on the potential for such events to affect the subject matter and to affect the appropriateness of the practitioner's conclusions. For some assurance engagements the nature of the subject matter may be such that consideration of subsequent events is not relevant to the conclusion. For example, when the engagement is to provide a conclusion about the accuracy of a statistical return at a point in time, events occurring after that point in time, but before the date of the practitioner's report, may not affect the conclusion.

Using the Work of an Expert

61. **When an expert is used in the collection and evaluation of evidence, the practitioner and the expert should, on a combined basis, possess adequate knowledge of the subject matter and have adequate proficiency in the subject matter for the practitioner to determine that sufficient appropriate evidence has been obtained.**
62. The subject matter and related criteria of some assurance engagements may be composed of a number of elements requiring specialized knowledge and skills in the collection and evaluation of evidence. In these situations, the practitioner may decide to use the work of persons from other professional disciplines, referred to as experts, who have the required skills and knowledge of the relevant aspects of the subject matter or criteria. This Standard does not provide guidance on engagements where there is joint responsibility and reporting by a practitioner and one or more experts.

63. Due care is a required professional quality for all individuals, including experts, involved in an assurance engagement. Persons involved in assurance engagements will have varying responsibilities assigned to them. The extent of proficiency required in performing those engagements will vary with the nature of their responsibilities. While experts do not require the same proficiency as the practitioner in performing all the components of an assurance engagement, the practitioner determines that the experts have a sufficient understanding of this Standard to enable them to relate the work assigned to them to the engagement objective.
64. The exercise of due care requires that all persons involved in an assurance engagement comply with these Assurance Standards, including any subject matter experts who are not professional accountants. The quality control procedures adopted by the practitioner will address the responsibility of each person performing the assurance engagement to comply with this Standard in the context of their responsibilities in the engagement process.
65. **When an expert is involved, the practitioner should have a level of involvement in the engagement and an understanding of the aspects of the subject matter for which the expert has been used, sufficient to enable the practitioner to accept responsibility for expressing a conclusion on the subject matter.** The practitioner considers the extent to which the practitioner will rely on the work of an expert in forming a conclusion on the subject matter.
66. The practitioner is not expected to possess the same specialized knowledge and skills as the expert. However, the practitioner needs to have a reasonable understanding to:
 - (a) Define the objectives of the work assigned to the expert and how this work relates to the objective of the engagement;
 - (b) Consider the reasonableness of the assumptions, methods and source data used by the expert; and
 - (c) Consider the reasonableness of the findings of the expert in relation to the objective of the engagement.
67. **When an expert is involved, the practitioner should obtain sufficient appropriate evidence that the work of the expert is adequate for the purposes of the assurance engagement.** The practitioner evaluates the sufficiency and appropriateness of the evidence provided by the expert by considering and assessing:
 - (a) The professional competence, experience and objectivity of the expert;
 - (b) The reasonableness of the assumptions, methods and source data used by the expert; and
 - (c) The reasonableness and significance of the expert's findings in relation to the objective of the engagement and the conclusion on the subject matter.

Reporting

68. **The report should express a conclusion that conveys a high level of assurance about the subject matter, based on the results of the work performed. The practitioner's report should contain a clear expression of the practitioner's opinion about a subject matter based on the identified suitable criteria and the evidence obtained in the course of the assurance engagement.** The report can take various forms, such as written (in hard copy or electronic form), oral, or by symbolic representation. However, a written report is generally the most effective form for adequately presenting the detail required and evidencing the conclusions provided. Oral and other forms of expressing the conclusion are open to misunderstanding without the support of a written report. For this reason, the practitioner will not ordinarily report orally without also providing a definitive written report.
69. This Standard does not require a standardized format for reporting on all assurance engagements but rather identifies the minimum information required to be included in the report. These minimum requirements may be tailored to the specific engagement circumstances. For certain assurance engagements, the practitioner may choose to adopt a flexible approach using a narrative (or "long form") style of reporting rather than a standardized (or "short form") format. This will result in more engagement-specific reports to facilitate effective communication to the intended user of the conclusion expressed.
70. The form of conclusion to be expressed by the practitioner is determined by the nature of the subject matter and the agreed objective of the engagement and is designed to meet the needs of the intended user of the report of the practitioner.

Report Content

71. **The practitioner's report should include:**
 - (a) **Title:** an appropriate title helps to identify the nature of the assurance engagement being provided, the nature of the report and to distinguish the practitioner's report from reports issued by others such as those who do not have to abide by the same ethical requirements as the practitioner;
 - (b) **An addressee:** an addressee identifies the party or parties to whom the report is directed;
 - (c) **A description of the engagement and identification of the subject matter:** the description includes the engagement objective, the subject matter, and (when appropriate) the time period covered;
 - (d) **A statement to identify the responsible party and describe the practitioner's responsibilities:** this informs the reader that the responsible party is responsible for the subject matter and that the practitioner's role is to express a conclusion about the subject matter;

- (e) **When the report is for a restricted purpose, identification of the parties to whom the report is restricted and for what purpose it was prepared:** while the practitioner cannot control the distribution of the report, this will inform readers of the party or parties to whom the report is restricted and for what purpose, and provides a caution to readers other than those identified that the report is intended only for the purposes specified;
- (f) **Identification of the standards under which the engagement was conducted:** when a practitioner performs an engagement for which specific standards exist, the report identifies those specific standards. When specific standards do not exist, the report states that the engagement was performed in accordance with this Standard. The report includes a description of the engagement process and identifies the nature and extent of procedures applied;
- (g) **Identification of the criteria:** the report identifies the criteria against which the subject matter was evaluated or measured so that readers can understand the basis for the practitioner's conclusions. The criteria may either be described in the practitioner's report or simply be referred to if they are set out in an assertion prepared by the responsible party or exist in a readily accessible source. Disclosure of the source of the criteria and whether or not the criteria are generally accepted in the context of the purpose of the engagement and the nature of the subject matter is important in understanding the conclusions expressed;
- (h) **The practitioner's conclusion, including any reservations or denial of a conclusion:** the report informs users of the practitioner's conclusion about the subject matter evaluated against the criteria and conveys a high level of assurance expressed in the form of an opinion. Where the engagement has more than one objective, a conclusion on each objective is expressed. Where the practitioner expresses a reservation or denial of conclusion, the report contains a clear description of all the reasons;
- (i) **The report date:** the date informs users that the practitioner has considered the effect on the subject matter of material events of which the practitioner became aware up to that date; and
- (j) **The name of the firm or the practitioner and the place of issue of the report:** the name informs the readers of the individual or firm assuming responsibility for the engagement;

72. The practitioner may expand the report to include other information and explanations not intended as a reservation. Other examples include findings relating to particular aspects of the engagement and recommendations of the practitioner or references to the inherent limitations of the subject matter. When considering whether to include any such information, the practitioner assesses the significance of that information in the context of the objective of the engagement. Additional information is not to be worded in such a manner

to affect the conclusion of the practitioner. The practitioner considers the use of appropriate headings to identify the principal sections of the report as a means of improving communication.

Reservation or Denial of Conclusion

73. **The conclusion should clearly express circumstances where:**
- (a) **The practitioner is of the view that one, some or all aspects of the subject matter do not conform to the identified criteria;**
 - (b) **The assertion prepared by the responsible party is inappropriate in terms of the identified criteria; or**
 - (c) **The practitioner is unable to obtain sufficient appropriate evidence to evaluate one or more aspects of the subject matter’s conformity with the identified criteria.**

Where the practitioner expresses a reservation about the subject matter, the nature and expression of that reservation is determined by the materiality of the matter giving rise to the reservation, for example, whether it relates to some or all aspects of the subject matter not conforming to the criteria (disagreement), or the inability of the practitioner to obtain sufficient appropriate evidence on some or all aspects of the subject matter (limitation of scope). When the practitioner expresses a reservation of conclusion or a denial of conclusion, the report discloses all significant facts and reasons relating to the reservation or denial.

Effective Date

74. This ISAE is effective for assurance engagements intended to provide a high level of assurance where the report is dated on or after December 31, 2001. Earlier application is encouraged.

Public Sector Perspective

1. *The Public Sector Committee (PSC) considers and makes use of the pronouncements issued by the International Auditing Practices Committee for their application in the public sector. “Public sector” refers to national governments, regional (state, provincial, territorial) governments, local (city, town) governments and related governmental entities (agencies, boards, commissions and enterprises).*
2. *Irrespective of whether an assurance engagement is being conducted in the private or public sectors, the basic principles remain the same. However, the application of the principles may need to be clarified or supplemented to accommodate the public sector circumstances and perspective of individual jurisdictions. The nature of potential matters for clarification and supplementation is identified in the “Public Sector Perspective (PSP)”*

included at the end of each International Standard on Assurance Engagements (International Standard) when required.

3. *If no PSP is included at the end of an International Standard, then the International Standard is applicable in all material respects to an assurance engagement in the public sector.*

Assurance Engagements in the Public Sector—Specific considerations

4. *Professional accountants appointed to perform an assurance engagement in the public sector need to take account of the specific requirements of any relevant regulations, ordinances or ministerial directives that affect the mandate, or any special requirements. The mandate and requirements may affect certain aspects of the assurance engagement, such as, the extent of the professional accountant's discretion in establishing materiality, and in the form of the report. In particular, legislation and regulations often specify requirements relating to the subject matter and the reporting of certain assurance engagements in the public sector.*
5. *While the standards on high level assurance engagements are limited to professional accountants in public practice (practitioners), the basic principles are also applicable to professional accountants undertaking such engagements in the public sector, such as public sector auditors.*

Subject Matter

6. *The mandate and legal requirements affecting professional accountants often encompass a wide range of objectives and subject matter. For example, professional accountants may be required to report on the reliability and appropriateness of performance indicators included in a public sector entity's annual report, relating to such matters as productivity levels, quality and volume of service and the extent to which particular service delivery objectives have been achieved. In addition, professional accountants may be required to report on:*
 - *Compliance with legislative or regulatory requirements and related authorities;*
 - *Adequacy of accounting and control systems; and*
 - *Economy, efficiency and effectiveness of programs, projects and activities.*
7. *In these engagements, the professional accountant may attest to a report or assertion regarding the subject matter, or may directly report their evaluation of the subject matter. Professional accountants may be required to report not only on the reliability of a performance report of a government program, but also on the relevance of performance measures to the objectives of that program.*

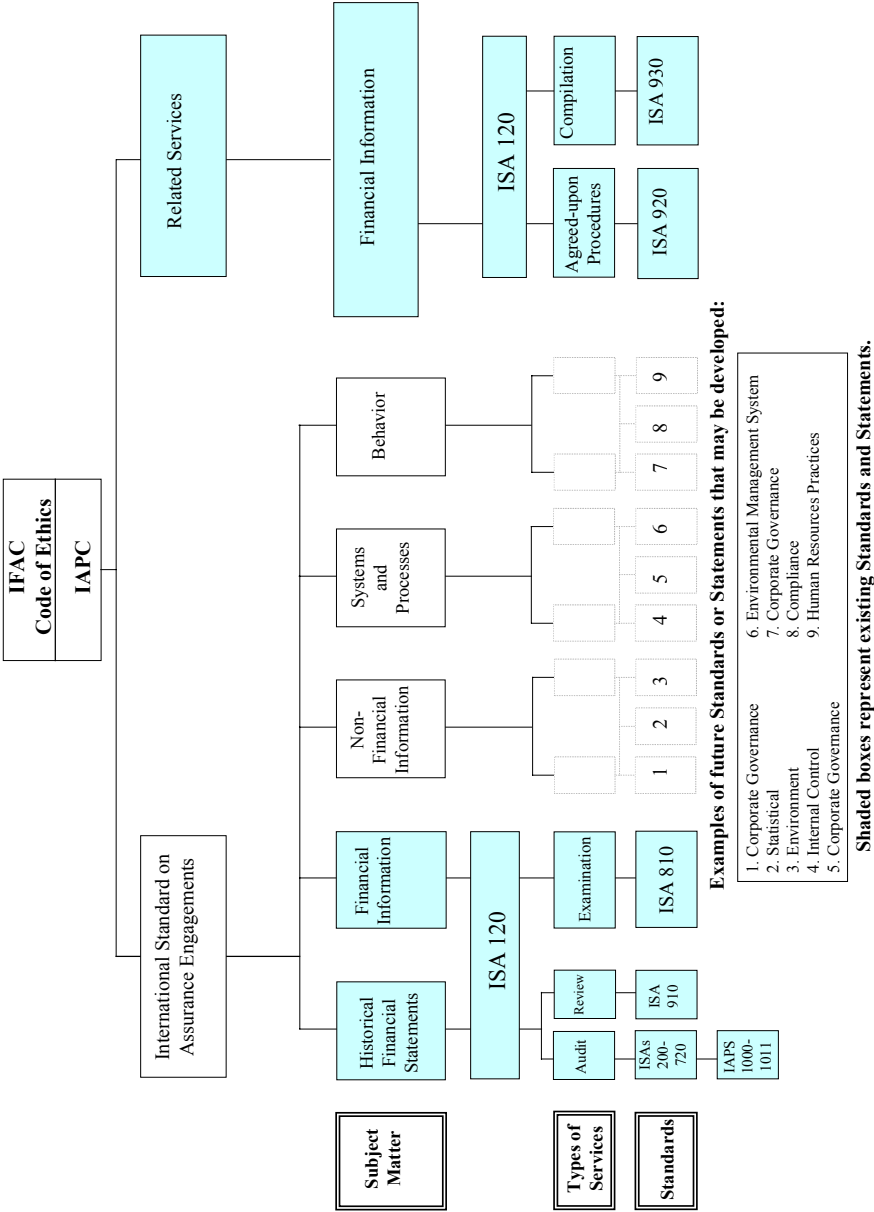
Reporting

8. *Professional accountants often undertake direct reporting assignment, since the responsible party may not have prepared a written assertion. While the reports generally should contain the elements described in paragraph 71, such reports are often long-form, describing in more detail the objective of the engagement, the criteria, the findings and conclusions. Professional accountants may also include recommendations in their reports.*
9. *Some mandates may require professional accountants to report instances of non-compliance, or instances where management has not handled matters with due regard to economy, efficiency and effectiveness. It should nevertheless be recognized that the framework contemplates that the report will contain a clear expression of the professional accountant's conclusion about the subject matter.*

Appendix

Relationship with Existing ISAs

The diagram on the following page indicates the relationship between this ISAE and the IAPC's existing ISAs and IAPs.



Report on the Issues Arising from Exposure Drafts of the International Standard on Assurance Engagements

Chronology

1. In August 1997, the IAPC issued an exposure draft “Reporting on the Credibility of Information”. This initiative recognized the increasing demand for information on a broad range of subject matters to meet the needs of decision-makers, and the consequent need in both the private and public sectors for services that enhance the credibility of that information. The exposure draft introduced the concept of a continuum of levels of assurance that could be provided, with the level of assurance provided in a particular engagement being dependant upon the interrelationship of four variables.
2. The IAPC received strong support for the aims of the 1997 exposure draft. The vast majority of respondents agreed with the concept of a continuum of levels of assurance. However, many respondents believed that the concept would be difficult to apply in practice, and in particular that it would be difficult to ensure that any report would convey the level of assurance with the necessary precision.
3. In order to address the concerns expressed by respondents, the IAPC concluded that significant changes needed to be made to the 1997 exposure draft and, as a result, issued a second exposure draft “Assurance Engagements” in March 1999. This kept the concept of the continuum, but restricted the levels of assurance being provided to two levels: a high level and a moderate level.
4. The exposure period for the 1999 exposure draft ended in July 1999, and the IAPC has examined the issues raised in those responses. The responses to the 1999 exposure draft continued to support the underlying concepts in the document. There was agreement on how the concepts would be applied to assurance engagements intended to provide a high level of assurance. However, there was disagreement as to how the concepts would be applied to assurance engagements intended to provide a moderate level of assurance. A number of respondents believed that the model did not provide sufficient guidance as it did not explain adequately the interaction of the variables and how they result in a moderate level of assurance. In addition, there was not consensus on how the moderate level of assurance is best communicated. Two alternative models for the moderate level of assurance were identified: one based in the interaction of the variables and the other based on work effort.
5. Respondents agreed that the concepts could be applied in assurance engagements conducted by all professional accountants. However, many respondents questioned whether professional accountants not in public practice should be *required* to use any standard derived from those concepts, and whether such requirement could be enforced.

6. In June 2000 the IAPC issued an International Standard on Assurance Engagements (ISAE) taking into account the comments received on the 1999 exposure draft. In view of the support that the framework received, and the fact that there was agreement on the requirements for a high level assurance engagement, the ISAE provides a framework for all assurance engagements—both moderate level and high level assurance engagements—and sets standards and provides guidance for the performance of engagements intended to provide a high level of assurance. The IAPC decided that the standards and guidance should apply only to those assurance engagements conducted by professional accountants in public practice, but would not prohibit other professional accountants from applying the ISAE should they be able to do so.
7. In view of the lack of agreement on standards for engagements intended to provide a moderate level of assurance, the IAPC has decided not to proceed at this time with a standard on moderate level assurance engagements. However, in developing new standards for assurance engagements on specific subjects, the IAPC will consider whether it can develop standards for moderate-level assurance engagements where it believes it appropriate.
8. IAPC intends to conduct research with the objective of identifying the determinants of moderate level of assurance and their interaction, and the ways in which that level of assurance can be expressed.

Two Views of Moderate Assurance

9. As indicated in paragraph 4 there were two views expressed as to how professional accountants determine whether a particular engagement can be conducted to provide a moderate level of assurance. These are the interaction of variables view (as expressed in the 1997 and 1999 exposure drafts), and the work effort view.

Interaction of Variables View

10. The determination of the level of assurance that can be provided involves consideration of the inter-relationship between the following:

- (a) Subject Matter

Some subject matter is inherently more capable of reliable measurement and support by relatively conclusive evidence. All else being equal, a higher level of assurance can be provided about an historical and quantitative subject matter (for example, historical financial statements) than about a more subjective and qualitative subject matter (for example, ethical behavior or a financial forecast).

- (b) Criteria

While all criteria need to be suitable, depending on the nature of the subject matter some criteria provide a means for more reliable measurement of the subject matter. A lower level of assurance will be

provided when the criteria are qualitative rather than quantitative, for example criteria addressing standards of ethical conduct will be subjective and qualitative.

(c) Process

A major determinant of the level of assurance that can be provided is the nature, timing, and extent of the procedures adopted by the professional accountant to gather evidence on which to base the conclusion. The professional accountant determines the nature, timing and extent of the process to be applied to achieve the engagement objective. The higher the level of assurance to be provided, the more comprehensive must be the procedures performed.

(d) Quantity and Quality of Evidence

The professional accountant will, through the application of appropriate procedures, seek to obtain sufficient appropriate evidence as the basis for the provision of the level of assurance. The professional accountant evaluates the reliability of the evidence obtained. Ordinarily, the evidence available to the professional accountant is persuasive rather than conclusive. In conjunction with the nature and form of the subject matter, criteria and procedures, the reliability of the evidence itself can impact the overall sufficiency and appropriateness of the evidence available.

11. The level of assurance is determined by the nature of the subject matter, criteria and by both the quantity and quality of evidence obtained. The professional accountant uses professional judgment to determine the appropriate level of assurance taking into account the interrelationship of the four variables. The following two situations illustrate the inter-relationship of these variables that result in a moderate level of assurance:

(a) Subject matter capable of reliable measurement using objective criteria.

The professional accountant applies procedures of a different nature or less extensive procedures than in an audit. The resulting evidence, while lower in quantity or quality than would be required for audit, may be sufficient to support a moderate level of assurance.

(b) Subject matter measurement less reliable because suitable criteria are less objective.

In some situations the subjectivity of the criteria may cause the measurement of the subject matter to be less reliable. This may, regardless of the procedures performed, result in an inability to obtain sufficient and appropriate evidence to support a high level of assurance. However, the professional accountant may be able to plan and perform appropriate procedures to obtain the evidence necessary to support a moderate level of assurance.

12. To differentiate the levels of assurance described above and to assist users of the professional accountant's report to understand the level of assurance being provided, the report includes additional explanatory language reflecting the influence, in the particular engagement, of the factors identified in paragraph 10. The conclusion and explanatory language will facilitate the communication to report users and limit the potential for these users to take a level of assurance beyond that which is intended, and what is reasonable in the circumstances.

Work Effort View

13. The level of assurance provided by the professional accountant is determined based, in the first instance, on the users' needs (including cost considerations) and, secondly, by the procedures performed to obtain sufficient appropriate evidence. The criteria and subject matter are viewed as prerequisites to the engagement. Both are considered when deciding whether or not the professional accountant is able to accept the engagement. Once the professional accountant determines that the criteria and subject matter support an assurance engagement, it is the work effort (the nature, timing and extent of the procedures performed) that determines the level of assurance. Consequently, if the professional accountant concludes that the professional accountant is unable to perform a high-level assurance engagement because of concerns regarding the criteria or the subject matter, the professional accountant would also be unable to perform a moderate-level assurance engagement.
14. Criteria are such a critical element of an assurance engagement that they must conclusively meet all of the characteristics of suitability to support providing any level of assurance. Thus, either the criteria have the characteristics of suitable criteria or they do not. For example, it is not possible for criteria to be only somewhat relevant and reliable and, therefore, while not suitable for a high level of assurance engagement, still be considered adequate for a moderate-level assurance engagement. If criteria were not suitable in this regard, then they would not meet all of the characteristics of suitability defined in paragraph 22 of the International Standard for Assurance Engagements.
15. The subject matter of an assurance engagement needs to be identifiable, capable of consistent evaluation or measurement against suitable criteria, and in a form that can be subjected to procedures for gathering evidence to support that evaluation or measurement. Once again, therefore, consideration of the subject matter is an engagement acceptance decision that the professional accountant considers when deciding whether or not it is possible to perform an assurance engagement either at a high level or a moderate level of assurance.
16. When the subject matter is not capable of consistent measurement, or when the criteria do not meet one or more of the characteristics of suitable criteria, the professional accountant is unable to perform an assurance engagement as defined in the ISAE.

17. Since suitable criteria and the subject matter are engagement acceptance decisions, it is the work effort that determines the level of assurance provided. Professional judgment would be applied in determining the nature, timing and extent of procedures that would be performed in any particular engagement. Nevertheless, this model results in a high level of consistency in its application by different professional accountants in similar circumstances, and in the understanding by users of the level of assurance conveyed in the report.
18. In the professional accountant's report, in addition to the conclusion that expresses the level of assurance (either high or moderate, depending on the objective of the engagement), the professional accountant might consider including additional explanatory language regarding the degree of precision of the subject matter, or its inherent limitations, to help readers of the report put the professional accountant's conclusion in appropriate context. The explanatory language is not a reservation of the auditor's conclusion.
19. The model is necessarily rigorous to ensure that professional accountants are able to reach consistent conclusions, given the same set of circumstances, as to the level of assurance that can be provided. In situations when the criteria have not been adequately developed, the professional accountant would not be able to perform an assurance engagement, but would be able to perform special purpose engagements, or agreed-upon procedures engagements, to meet users' specific needs.

Further Research

20. As referred to in paragraph 8, the IAPC is conducting research to help resolve the above issue. Those who wish to provide comments to assist the research may do so through the IFAC secretariat.²

² The results of the research was issued in June 2002. Refer to Study 1, "The Determination and Communication of Levels of Assurance Other than High," which is available from the IAASB website at <http://www.iaasb.org>.

INTERNATIONAL STANDARD ON AUDITING 120

FRAMEWORK OF INTERNATIONAL STANDARDS ON AUDITING

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The International Auditing Practices Committee has been authorized to issue International Standards on Auditing (ISAs). The purpose of this document is to describe the framework within which ISAs are issued in relation to the services which may be performed by auditors.
2. For ease of reference, except where indicated, the term “auditor” is used throughout the ISAs when describing both auditing and related services which may be performed. Such reference is not intended to imply that a person performing related services need be the auditor of the entity’s financial statements.

Financial Reporting Framework

3. Financial statements are ordinarily prepared and presented annually and are directed toward the common information needs of a wide range of users. Many of those users rely on the financial statements as their major source of information because they do not have the power to obtain additional information to meet their specific information needs. Thus, financial statements need to be prepared in accordance with one, or a combination of:
 - (a) International Accounting Standards;
 - (b) National accounting standards; and
 - (c) Another authoritative and comprehensive financial reporting framework which has been designed for use in financial reporting and is identified in the financial statements.

Framework for Auditing and Related Services

4. This Framework distinguishes audits from related services. Related services comprise reviews, agreed-upon procedures and compilations. As illustrated in the diagram below, audits and reviews are designed to enable the auditor to provide high and moderate levels of assurance respectively, such terms being used to indicate their comparative ranking. Engagements to undertake agreed-upon procedures and compilations are not intended to enable the auditor to express assurance.

	Auditing	Related Services		
Nature of service	Audit	Review	Agreed-upon Procedures	Compilation
Comparative level of assurance provided by the auditor	High, but not absolute, assurance	Moderate assurance	No assurance	No assurance
Report provided	Positive assurance on assertion(s)	Negative assurance on assertion(s)	Factual findings of procedures	Identification of information compiled

5. The Framework does not apply to other services provided by auditors such as taxation, consultancy, and financial and accounting advice.

Levels of Assurance

6. Assurance in the context of this Framework refers to the auditor's satisfaction as to the reliability of an assertion being made by one party for use by another party. To provide such assurance, the auditor assesses the evidence collected as a result of procedures conducted and expresses a conclusion. The degree of satisfaction achieved and, therefore, the level of assurance which may be provided is determined by the procedures performed and their results.
7. In an audit engagement, the auditor provides a high, but not absolute, level of assurance that the information subject to audit is free of material misstatement. This is expressed positively in the audit report as reasonable assurance.
8. In a review engagement, the auditor provides a moderate level of assurance that the information subject to review is free of material misstatement. This is expressed in the form of negative assurance.
9. For agreed-upon procedures, as the auditor simply provides a report of the factual findings, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.
10. In a compilation engagement, although the users of the compiled information derive some benefit from the accountant's¹ involvement, no assurance is expressed in the report.

¹ To distinguish compilation engagements from audits and other related services the term "accountant" (rather than "auditor") has been used to refer to a professional accountant in public practice.

Audit

11. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The phrases used to express the auditor's opinion are "give a true and fair view" or "present fairly, in all material respects," which are equivalent terms. A similar objective applies to the audit of financial or other information prepared in accordance with appropriate criteria.
12. In forming the audit opinion, the auditor obtains sufficient appropriate audit evidence to be able to draw conclusions on which to base that opinion.
13. The auditor's opinion enhances the credibility of financial statements by providing a high, but not absolute, level of assurance. Absolute assurance in auditing is not attainable as a result of such factors as the need for judgment, the use of testing, the inherent limitations of any accounting and internal control systems and the fact that most of the evidence available to the auditor is persuasive, rather than conclusive, in nature.

Related Services

Reviews

14. The objective of a review of financial statements is to enable an auditor² to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework. A similar objective applies to the review of financial or other information prepared in accordance with appropriate criteria.
15. A review comprises inquiry and analytical procedures which are designed to review the reliability of an assertion that is the responsibility of one party for use by another party. While a review involves the application of audit skills and techniques and the gathering of evidence, it does not ordinarily involve an assessment of accounting and internal control systems, tests of records and of responses to inquiries by obtaining corroborating evidence through inspection, observation, confirmation and computation, which are procedures ordinarily performed during an audit.
16. Although the auditor attempts to become aware of all significant matters, the procedures of a review make the achievement of this objective less likely than in an audit engagement, thus the level of assurance provided in a review report is correspondingly less than that given in an audit report.

² As explained in paragraph 2 the term auditor is used when describing both auditing and related services. Such reference is not intended to imply that a person performing related services need be the auditor of the entity's financial statements.

Agreed-upon Procedures

17. In an engagement to perform agreed-upon procedures, an auditor³ is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

Compilations

18. In a compilation engagement, the accountant⁴ is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarize financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the accountant to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the accountant's involvement because the service has been performed with due professional skill and care.

Auditor Association with Financial Information

19. An auditor⁵ is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor's name in a professional connection. If the auditor is not associated in this manner, third parties can assume no responsibility of the auditor. If the auditor learns that an entity is inappropriately using the auditor's name in association with financial information, the auditor would require management to cease doing so and consider what further steps, if any, need to be taken, such as informing any known third party users of the information of the inappropriate use of the auditor's name in connection with the information. The auditor may also believe it necessary to take other action, for example, to seek legal advice.

Public Sector Perspective

1. *The Public Sector Committee (PSC) issues pronouncements aimed at developing and harmonizing public sector financial reporting, accounting and auditing practices. "Public Sector" refers to national governments, regional (state, provincial, territorial) governments, local (city, town) governments and related governmental entities (agencies, boards, commissions and enterprises). The PSC considers and makes use of pronouncements issued by the*

³ See footnote 2.

⁴ See footnote 1.

⁵ This includes an accountant engaged to perform compilation engagements.

International Auditing Practices Committee to the extent they are applicable to the public sector..

2. *Governments, government business enterprises and other non-business public sector entities ordinarily prepare financial statements to report on their financial position (or aspects thereof), results of operations and cash flows, for use by legislators, government departments, outside investors, employees, lenders, the public and other users. The audit of such financial statements may be the responsibility of a Supreme Audit Institution, other bodies appointed by statute or practicing auditors..*
3. *Whenever an audit opinion is to be expressed on financial statements, the same audit principles apply regardless of the nature of the entity, because users of audited financial statements are entitled to a uniform quality of audit performance. Since ISAs set out the basic audit principles and related practices and procedures, they apply to audits of the financial statements of governments and other public sector entities. However, the application of certain ISAs may need to be clarified or supplemented to accommodate the public sector circumstances and perspective of individual jurisdictions, particularly as they relate to the audits of governments and other non-business public sector entities. The nature of potential matters for clarification or supplementation is identified in the “Public Sector Perspective (PSP)” included at the end of each ISA..*
4. *The financial statements of governments, government business enterprises and other non-business public sector entities may include information that is different from, or in addition to, that contained in the financial statements of private sector entities (for example, comparisons of expenditures in the period with limits established by legislation). In such circumstances, appropriate modifications may be required to the nature, timing and extent of audit procedures, and the auditor’s report.*
5. *Further, governments and non-business public sector entities, as well as some government business enterprises, are required to achieve service delivery as well as financial objectives. For such entities, the financial statements, by themselves, are unlikely to adequately report on all aspects of the entity’s performance. Consequently, these public sector entities may be required to include in their annual report other performance indicators relating to such matters as productivity levels, quality and volume of service and the extent to which particular service delivery objectives have been achieved. The PSPs included in the ISAs are not intended to apply to the audit of such information.*
6. *In addition, the auditors of public sector entities may be required to report on:*
 - (a) *Compliance with legislative or regulatory requirements and related authorities;*
 - (b) *Adequacy of accounting and internal control systems; and*
 - (c) *Economy, efficiency and effectiveness of programs, projects and activities.*

The PSPs also do not apply to such reports.

7. *If no PSP is added at the end of an ISA, the ISA is applicable in all material respects to the audit of financial statements in the public sector.*

INTERNATIONAL STANDARD ON AUDITING 200

OBJECTIVE AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF FINANCIAL STATEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements. This ISA is to be read in conjunction with ISA 120 “Framework of International Standards on Auditing.”

Objective of an Audit

2. **The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.** The phrases used to express the auditor’s opinion are “give a true and fair view” or “present fairly, in all material respects,” which are equivalent terms.
3. Although the auditor’s opinion enhances the credibility of the financial statements, the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

General Principles of an Audit

4. **The auditor should comply with the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.** Ethical principles governing the auditor’s professional responsibilities are:
 - (a) Independence;
 - (b) Integrity;
 - (c) Objectivity;
 - (d) Professional competence and due care;
 - (e) Confidentiality;
 - (f) Professional behavior; and
 - (g) Technical standards.
5. **The auditor should conduct an audit in accordance with ISAs.** These contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.
6. **The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.** An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of

documents or management representations. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of overgeneralizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.¹

Scope of an Audit

7. The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit. **The procedures required to conduct an audit in accordance with ISAs should be determined by the auditor having regard to the requirements of ISAs, relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements.**

Reasonable Assurance

8. An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.
9. However, there are inherent limitations in an audit that affect the auditor’s ability to detect material misstatements. These limitations result from factors such as:
 - The use of testing.
 - The inherent limitations of any accounting and internal control system (for example, the possibility of collusion).
 - The fact that most audit evidence is persuasive rather than conclusive.

¹ Paragraph 6 reflects the changes indicated in ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” and is effective for audits of financial statements for periods ending on or after June 30, 2002. The original Paragraph 6 is indicated below:

The auditor should plan and perform the audit with an attitude of professional skepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated. For example, the auditor would ordinarily expect to find evidence to support management representations and not assume they are necessarily correct.

10. Also, the work undertaken by the auditor to form an opinion is permeated by judgment, in particular regarding:
 - (a) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and
 - (b) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.
11. Further, other limitations may affect the persuasiveness of evidence available to draw conclusions on particular financial statement assertions (for example, transactions between related parties). In these cases certain ISAs identify specified procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:
 - (a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or
 - (b) Any indication that a material misstatement has occurred.

Responsibility for the Financial Statements

12. While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements is that of the management of the entity. The audit of the financial statements does not relieve management of its responsibilities.

Public Sector Perspective

1. *Irrespective of whether an audit is being conducted in the private or public sector, the basic principles of auditing remain the same. What may differ for audits carried out in the public sector is the audit objective and scope. These factors are often attributable to differences in the audit mandate and legal requirements or the form of reporting (for example, public sector entities may be required to prepare additional financial reports).*
2. *When carrying out audits of public sector entities, the auditor will need to take into account the specific requirements of any other relevant regulations, ordinances or ministerial directives which affect the audit mandate and any special auditing requirements, including the need to have regard to issues of national security. Audit mandates may be more specific than those in the private sector, and often encompass a wider range of objectives and a broader scope than is ordinarily applicable for the audit of private sector financial statements. The mandates and requirements may also effect, for example, the extent of the auditor's discretion in establishing materiality, in reporting fraud and error, and in the form of the audit report. Differences in audit approach and style may also exist. However, these differences would not constitute a difference in the basic principles and essential procedures.*

INTERNATIONAL STANDARD ON AUDITING 210

TERMS OF AUDIT ENGAGEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on:
 - (a) agreeing the terms of the engagement with the client; and
 - (b) the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.
2. **The auditor and the client should agree on the terms of the engagement.** The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.
3. This ISA is intended to assist the auditor in the preparation of engagement letters relating to audits of financial statements. The guidance is also applicable to related services. When other services such as tax, accounting, or management advisory services are to be provided, separate letters may be appropriate.
4. In some countries, the objective and scope of an audit and the auditor's obligations are established by law. Even in those situations the auditor may still find audit engagement letters informative for their clients.

Audit Engagement Letters

5. It is in the interest of both client and auditor that the auditor sends an engagement letter, preferably before the commencement of the engagement, to help in avoiding misunderstandings with respect to the engagement. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.

Principal Contents

6. The form and content of audit engagement letters may vary for each client, but they would generally include reference to:
 - The objective of the audit of financial statements.
 - Management's responsibility for the financial statements.
 - The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres.
 - The form of any reports or other communication of results of the engagement.
 - The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal

control system, there is an unavoidable risk that even some material misstatement may remain undiscovered.

- Unrestricted access to whatever records, documentation and other information requested in connection with the audit.
7. The auditor may also wish to include in the letter:
 - Arrangements regarding the planning of the audit.
 - Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
 - Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
 - Description of any other letters or reports the auditor expects to issue to the client.
 - Basis on which fees are computed and any billing arrangements.
 8. When relevant, the following points could also be made:
 - Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
 - Arrangements concerning the involvement of internal auditors and other client staff.
 - Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
 - Any restriction of the auditor's liability when such possibility exists.
 - A reference to any further agreements between the auditor and the client.

An example of an audit engagement letter is set out in the Appendix.

Audits of Components

9. When the auditor of a parent entity is also the auditor of its subsidiary, branch or division (component), the factors that influence the decision whether to send a separate engagement letter to the component include:
 - Who appoints the auditor of the component.
 - Whether a separate audit report is to be issued on the component.
 - Legal requirements.
 - The extent of any work performed by other auditors.
 - Degree of ownership by parent.
 - Degree of independence of the component's management.

Recurring Audits

10. **On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.**
11. The auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:
 - Any indication that the client misunderstands the objective and scope of the audit.
 - Any revised or special terms of the engagement.
 - A recent change of senior management, board of directors or ownership.
 - A significant change in nature or size of the client's business.
 - Legal requirements.

Acceptance of a Change in Engagement

12. **An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.**
13. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement.
14. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of service originally requested would ordinarily be considered a reasonable basis for requesting a change in the engagement. In contrast a change would not be considered reasonable if it appeared that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.
15. Before agreeing to change an audit engagement to a related service, an auditor who was engaged to perform an audit in accordance with ISAs would consider, in addition to the above matters, any legal or contractual implications of the change.
16. If the auditor concludes, that there is reasonable justification to change the engagement and if the audit work performed complies with the ISAs applicable to the changed engagement, the report issued would be that appropriate for the revised terms of engagement. In order to avoid confusing the reader, the report would not include reference to:

- (a) The original engagement; or
 - (b) Any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.
17. **Where the terms of the engagement are changed, the auditor and the client should agree on the new terms.**
 18. **The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.** An example might be an audit engagement where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the client asks for the engagement to be changed to a review engagement to avoid a qualified audit opinion or a disclaimer of opinion.
 19. **If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report to other parties, such as the board of directors or shareholders, the circumstances necessitating the withdrawal.**

Public Sector Perspective

1. *The purpose of the engagement letter is to inform the auditee of the nature of the engagement and to clarify the responsibilities of the parties involved. The legislation and regulations governing the operations of public sector audits generally mandate the appointment of a public sector auditor and the use of audit engagement letters may not be a widespread practice. Nevertheless, a letter setting out the nature of the engagement or recognizing an engagement not indicated in the legislative mandate may be useful to both parties. Public sector auditors have to give serious consideration to issuing audit engagements letters when undertaking an audit.*
2. *Paragraphs 12 to 19 of this ISA deal with the action a private sector auditor may take when there are attempts to change an audit engagement to one which provides a lower level of assurance. In the public sector specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a minister, the legislature or the public if management (including the department head) attempts to limit the scope of the audit.*

Appendix

Example of an Audit Engagement Letter

The following letter is for use as a guide in conjunction with the considerations outlined in this ISA and will need to be varied according to individual requirements and circumstances.

To the Board of Directors or the appropriate representative of senior management:

You have requested that we audit the balance sheet of as of, and the related statements of income and cash flows for the year then ending. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be made with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which come to our notice.

We remind you that the responsibility for the preparation of financial statements including adequate disclosure is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies, and the safeguarding of the assets of the company. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit. Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary

according to the degree of responsibility involved and the experience and skill required.

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

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.

Acknowledged on behalf of
ABC Company by

(signed)

.....

Name and Title

Date

INTERNATIONAL STANDARD ON AUDITING 220

QUALITY CONTROL FOR AUDIT WORK

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

¹ Reference may also be made to the International Professional Practice Statement 1 of the International Federation of Accountants “Assuring the Quality of Professional Services.”

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the quality control:
 - (a) Policies and procedures of an audit firm regarding audit work generally; and
 - (b) Procedures regarding the work delegated to assistants on an individual audit.
2. **Quality control policies and procedures should be implemented at both the level of the audit firm and on individual audits.**
3. In this ISA the following terms have the meaning attributed below:
 - (a) “The auditor” means the person with final responsibility for the audit;
 - (b) “Audit firm” means either the partners of a firm providing audit services or a sole practitioner providing audit services, as appropriate;
 - (c) “Personnel” means all partners and professional staff engaged in the audit practice of the firm; and
 - (d) “Assistants” means personnel involved in an individual audit other than the auditor.

Audit Firm

4. **The audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with ISAs or relevant national standards or practices.**
5. The nature, timing and extent of an audit firm’s quality control policies and procedures depend on a number of factors such as the size and nature of its practice, its geographic dispersion, its organization and appropriate cost/benefit considerations. Accordingly, the policies and procedures adopted by individual audit firms will vary, as will the extent of their documentation. Illustrative examples of quality control procedures are presented in the Appendix to this ISA.
6. The objectives of the quality control policies to be adopted by an audit firm will ordinarily incorporate the following:
 - (a) Professional Requirements:²
Personnel in the firm are to adhere to the principles of independence, integrity, objectivity, confidentiality and professional behavior.

² Refer to the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants and the requirement on auditors to observe these in ISA 200 “Objective and General Principles Governing an Audit of Financial Statements.”

(b) Skills and Competence:³

The firm is to be staffed by personnel who have attained and maintain the technical standards and professional competence required to enable them to fulfill their responsibilities with due care.

(c) Assignment:

Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

(d) Delegation:

There is to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.

(e) Consultation:

Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.

(f) Acceptance and Retention of Clients:

An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly and the integrity of the client's management are to be considered.

(g) Monitoring:

The continued adequacy and operational effectiveness of quality control policies and procedures is to be monitored.

7. **The firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood and implemented.**

Individual Audits

8. **The auditor should implement those quality control procedures which are, in the context of the policies and procedures of the firm, appropriate to the individual audit.**
9. The auditor, and assistants with supervisory responsibilities, will consider the professional competence of assistants performing work delegated to them when deciding the extent of direction, supervision and review appropriate for each assistant.
10. Any delegation of work to assistants would be in a manner that provides reasonable assurance that such work will be performed with due care by persons having the degree of professional competence required in the circumstances.

³ See footnote 2.

Direction

11. Assistants to whom work is delegated need appropriate direction. Direction involves informing assistants of their responsibilities and the objectives of the procedures they are to perform. It also involves informing them of matters, such as the nature of the entity's business and possible accounting or auditing problems that may affect the nature, timing and extent of audit procedures with which they are involved.
12. The audit program is an important tool for the communication of audit directions. Time budgets and the overall audit plan are also helpful in communicating audit directions.

Supervision

13. Supervision is closely related to both direction and review and may involve elements of both.
14. Personnel carrying out supervisory responsibilities perform the following functions during the audit:
 - (a) Monitor the progress of the audit to consider whether:
 - (i) Assistants have the necessary skills and competence to carry out their assigned tasks;
 - (ii) Assistants understand the audit directions; and
 - (iii) The work is being carried out in accordance with the overall audit plan and the audit program;
 - (b) Become informed of and address significant accounting and auditing questions raised during the audit, by assessing their significance and modifying the overall audit plan and the audit program as appropriate; and
 - (c) Resolve any differences of professional judgment between personnel and consider the level of consultation that is appropriate.

Review

15. The work performed by each assistant needs to be reviewed by personnel of at least equal competence to consider whether:
 - (a) The work has been performed in accordance with the audit program;
 - (b) The work performed and the results obtained have been adequately documented;
 - (c) All significant audit matters have been resolved or are reflected in audit conclusions;
 - (d) The objectives of the audit procedures have been achieved; and

- (e) The conclusions expressed are consistent with the results of the work performed and support the audit opinion.
16. The following need to be reviewed on a timely basis:
- (a) The overall audit plan and the audit program;
 - (b) The assessments of inherent and control risks, including the results of tests of control and the modifications, if any, made to the overall audit plan and the audit program as a result thereof;
 - (c) The documentation of the audit evidence obtained from substantive procedures and the conclusions drawn therefrom, including the results of consultations; and
 - (d) The financial statements, proposed audit adjustments and the proposed auditor's report.
17. The process of reviewing an audit may include, particularly in the case of large complex audits, requesting personnel not otherwise involved in the audit to perform certain additional procedures before issuing the auditor's report.

Public Sector Perspective

1. *This ISA refers to the work of private sector audit firms. Many audits of governments and other public sector entities are carried out by Supreme Audit Institutions (SAIs), other bodies appointed by statute or practicing auditors. The general principles in this ISA on quality control apply equally to SAIs. However, some of the specific policies and procedures may not be applicable (for example, acceptance and retention of clients, SAIs organized on a collegial basis) and there may be additional policies relevant to public sector auditors.*
2. *Also, in the public sector of some countries, quality control generally has a different meaning to that adopted in this ISA. Quality assurance is the term applied to internal supervision and review procedures whereas quality control is the term applied to external quality reviews.*

Appendix

Illustrative Examples of Quality Control Procedures for an Audit Firm

A. PROFESSIONAL REQUIREMENTS

Policy

Personnel in the firm are to adhere to the principles of independence, integrity, objectivity, confidentiality and professional behavior.

Procedures

1. Assign an individual or group to provide guidance and to resolve questions on matters of integrity, objectivity, independence and confidentiality.
 - (a) Identify circumstances where documentation as to the resolution of questions would be appropriate.
 - (b) Require consultation with authoritative sources when considered necessary.
2. Communicate policies and procedures regarding independence, integrity, objectivity, confidentiality and professional behavior to personnel at all levels within the firm.
 - (a) Inform personnel of the firm's policies and procedures and advise them that they are expected to be familiar with them.
 - (b) Emphasize independence of mental attitude in training programs and in supervision and review of audits.
 - (c) Inform personnel on a timely basis of those entities to which independence policies apply.
 - (d) Prepare and maintain for independence purposes a list of the firm's clients and of other entities (client's affiliates, parents, associates, and so forth) to which independence policies apply.
 - (i) Make the list available to personnel (including personnel new to the firm or to an office) who need it to determine their independence.
 - (ii) Establish procedures to notify personnel of changes in the list.
3. Monitor compliance with policies and procedures relating to independence, integrity, objectivity, confidentiality and professional behavior.
 - (a) Obtain from personnel periodic written representations, ordinarily on an annual basis, stating that:
 - (i) They are familiar with the firm's policies and procedures.

- (ii) Prohibited investments are not held and were not held during the period.
 - (iii) Prohibited relationships do not exist, and transactions prohibited by firm policy have not occurred.
- (b) Assign responsibility for resolving exceptions to a person or group with appropriate authority.
- (c) Assign responsibility for obtaining representations and reviewing independence compliance files for completeness to a person or group with appropriate authority.
- (d) Review periodically the firm's association with clients to ascertain whether any areas of involvement may or may be seen to impair the firm's independence.

B. SKILLS AND COMPETENCE

Policy

The firm is to be staffed by personnel who have attained and maintain the technical standards and professional competence required to enable them to fulfill their responsibilities with due care.

Procedures

Hiring

1. Maintain a program designed to obtain qualified personnel by planning for personnel needs, establishing hiring objectives, and setting qualifications for those involved in the hiring function.
 - (a) Plan for the firm's personnel needs at all levels and establish quantified hiring objectives based on current clientele, anticipated growth, and retirement.
 - (b) Design a program to achieve hiring objectives which provides for—
 - (i) Identification of sources of potential hires.
 - (ii) Methods of contact with potential hires.
 - (iii) Methods of specific identification of potential hires.
 - (iv) Methods of attracting potential hires and informing them about the firm.
 - (v) Methods of evaluating and selecting potential hires for extension of employment offers.
 - (c) Inform those persons involved in hiring as to the firm's personnel needs and hiring objectives.

- (d) Assign to authorized persons the responsibility for employment decisions.
 - (e) Monitor the effectiveness of the recruiting program.
 - (i) Evaluate the recruiting program periodically to determine whether policies and procedures for obtaining qualified personnel are being observed.
 - (ii) Review hiring results periodically to determine whether goals and personnel needs are being achieved.
2. Establish qualifications and guidelines for evaluating potential hirees at each professional level.
- (a) Identify the attributes to be sought in hirees, such as intelligence, integrity, honesty, motivation and aptitude for the profession.
 - (b) Identify achievements and experiences desirable for entry level and experienced personnel. For example:
 - (i) Academic background.
 - (ii) Personal achievements.
 - (iii) Work experience.
 - (iv) Personal interests.
 - (c) Set guidelines to be followed when hiring individuals in situations such as:
 - (i) Hiring relatives of personnel or relatives of clients.
 - (ii) Rehiring former employees.
 - (iii) Hiring client employees.
 - (d) Obtain background information and documentation of qualifications of applicants by appropriate means, such as:
 - (i) Resumes.
 - (ii) Application forms.
 - (iii) Interviews.
 - (iv) Academic record.
 - (v) Personal references.
 - (vi) Former employment references.
 - (e) Evaluate the qualifications of new personnel, including those obtained from other than the usual hiring channels (for example, those joining the firm at supervisory levels or through merger or acquisition), to determine that they meet the firm's requirements and standards.

3. Inform applicants and new personnel of the firm's policies and procedures relevant to them.
 - (a) Use a brochure or other means to inform applicants and new personnel.
 - (b) Prepare and maintain a manual describing policies and procedures for distribution to personnel.
 - (c) Conduct an orientation program for new personnel.

Professional Development

4. Establish guidelines and requirements for continuing professional education and communicate them to personnel.
 - (a) Assign responsibility for the professional development function to a person or group with appropriate authority.
 - (b) Provide that programs developed by the firm be reviewed by qualified individuals. Programs would contain statements of objectives and education and/or experience prerequisites.
 - (c) Provide an orientation program relating to the firm and the profession for newly employed personnel.
 - (i) Prepare publications and programs designed to inform newly employed personnel of their professional responsibilities and opportunities.
 - (ii) Assign responsibility for conducting orientation conferences to explain professional responsibilities and firm policies.
 - (d) Establish continuing professional education requirements for personnel at each level within the firm.
 - (i) Consider legislative and professional bodies' requirements or voluntary guidelines in establishing firm requirements.
 - (ii) Encourage participation in external continuing professional education programs, including self-study courses.
 - (iii) Encourage membership in professional organizations. Consider having the firm pay or contribute toward membership dues and expenses.
 - (iv) Encourage personnel to serve on professional committees, prepare articles, and participate in other professional activities.
 - (e) Monitor continuing professional education programs and maintain appropriate records, both on a firm and an individual basis.
 - (i) Review periodically the records of participation by personnel to determine compliance with firm requirements.

- (ii) Review periodically evaluation reports and other records prepared for continuing education programs to evaluate whether the programs are being presented effectively and are accomplishing firm objectives. Consider the need for new programs and for revision or elimination of ineffective programs.
- 5. Make available to personnel information about current developments in professional technical standards and materials containing the firm's technical policies and procedures and encourage personnel to engage in self-development activities.
 - (a) Provide personnel with professional literature relating to current developments in professional technical standards.
 - (i) Distribute to personnel material of general interest, such as relevant international and national pronouncements on accounting and auditing matters.
 - (ii) Distribute pronouncements on relevant regulations and statutory requirements in areas of specific interest, such as company securities and taxation law, to persons who have responsibility in such areas.
 - (iii) Distribute manuals containing firm policies and procedures on technical matters to personnel. Manuals need to be updated for new developments and changing conditions.
 - (b) For training programs presented by the firm, develop or obtain course materials and select and train instructors.
 - (i) State the program objectives and education and/or experience prerequisites in the training programs.
 - (ii) Provide that program instructors be qualified as to both program content and teaching methods.
 - (iii) Have participants evaluate program content and instructors of training sessions.
 - (iv) Have instructors evaluate program content and participants in training sessions.
 - (v) Update programs as needed in light of new developments, changing conditions, and evaluation reports.
 - (vi) Maintain a library or other facility containing professional, regulatory and firm literature relating to professional technical matters.
- 6. Provide, to the extent necessary, programs to fill the firm's needs for personnel with expertise in specialized areas and industries.
 - (a) Conduct firm programs to develop and maintain expertise in specialized areas and industries, such as regulated industries, computer auditing, and statistical sampling methods.

- (b) Encourage attendance at external education programs, meetings, and conferences to acquire technical or industry expertise.
- (c) Encourage membership and participation in organizations concerned with specialized areas and industries.
- (d) Provide technical literature relating to specialized areas and industries.

Advancement

- 7. Establish qualifications deemed necessary for the various levels of responsibility within the firm.
 - (a) Prepare guidelines describing responsibilities at each level and expected performance and qualifications necessary for advancement to each level, including:
 - (i) Titles and related responsibilities.
 - (ii) The amount of experience (which may be expressed as a time period) generally required for advancement to the succeeding level.
 - (b) Identify criteria which will be considered in evaluating individual performance and expected proficiency, such as:
 - (i) Technical knowledge.
 - (ii) Analytical and judgmental abilities.
 - (iii) Communication skills.
 - (iv) Leadership and training skills.
 - (v) Client relations.
 - (vi) Personal attitude and professional bearing (character, intelligence, judgment and motivation).
 - (vii) Qualification as a professional accountant for advancement to a supervisory position.
 - (c) Use a personnel manual or other means to communicate advancement policies and procedures to personnel.
- 8. Evaluate performance of personnel and advise personnel of their progress.
 - (a) Gather and evaluate information on performance of personnel.
 - (i) Identify evaluation responsibilities and requirements at each level indicating who will prepare evaluations and when they will be prepared.
 - (ii) Instruct personnel on the objectives of personnel evaluation.
 - (iii) Utilize forms, which may be standardized, for evaluating performance of personnel.

- (iv) Review evaluations with the individual being evaluated.
 - (v) Require that evaluations be reviewed by the evaluator's superior.
 - (vi) Review evaluations to determine that individuals worked for and were evaluated by different persons.
 - (vii) Determine that evaluations are completed on a timely basis.
 - (viii) Maintain personnel files containing documentation relating to the evaluation process.
- (b) Periodically counsel personnel as to their progress and career opportunities.
- (i) Review periodically with personnel the evaluation of their performance, including an assessment of their progress with the firm. Considerations would include the following:
 - Performance.
 - Future objectives of the firm and the individual.
 - Assignment preference.
 - Career opportunities.
 - (ii) Evaluate partners periodically by means of senior partner or fellow partner evaluation and counseling as to whether they continue to have the qualifications to fulfill their responsibilities.
 - (iii) Review periodically the system of personnel evaluation and counseling to ascertain that:
 - Procedures for evaluation and documentation are being followed on a timely basis.
 - Requirements established for advancement are being achieved.
 - Personnel decisions are consistent with evaluations.
 - Recognition is given to outstanding performance.
9. Assign responsibility for making advancement decisions.
- (a) Assign responsibility to designated persons for making advancement and termination decisions, conducting evaluation interviews with persons considered for advancement, documenting the results of the interviews, and maintaining appropriate records.
 - (b) Evaluate data obtained giving appropriate recognition in advancement decisions to the quality of the work performed.
 - (c) Study the firm's advancement experience periodically to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility.

C. ASSIGNMENT

Policy

Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

Procedures

1. Delineate the firm's approach to assigning personnel, including the planning of overall firm and office needs and the measures employed to achieve a balance of audit manpower requirements, personnel skills, individual development and utilization.
 - (a) Plan the personnel needs of the firm on an overall basis and for individual practice offices.
 - (b) Identify on a timely basis the staffing requirements of specific audits.
 - (c) Prepare time budgets for audits to determine manpower requirements and to schedule audit work.
 - (d) Consider the following factors in achieving a balance of audit manpower requirements, personal skills, individual development and utilization:
 - (i) Audit size and complexity.
 - (ii) Personnel availability.
 - (iii) Special expertise required.
 - (iv) Timing of the work to be performed.
 - (v) Continuity and periodic rotation of personnel.
 - (vi) Opportunities for on-the-job training.
2. Assign an appropriate person or persons to be responsible for assigning personnel to audits.
 - (a) Consider the following in making assignments of individuals:
 - (i) Staffing and timing requirements of the specific audit.
 - (ii) Evaluations of the qualifications of personnel as to experience, position, background, and special expertise.
 - (iii) The planned supervision and involvement by supervisory personnel.
 - (iv) Projected time availability of individuals assigned.
 - (v) Situations where possible independence problems and conflicts of interest may exist, such as assignment of personnel to audits for clients who are former employers or are employers of certain kin.

- (b) Give appropriate consideration, in assigning personnel, to both continuity and rotation to provide for efficient conduct of the audit and the perspective of other personnel with different experience and backgrounds.
- 3. Provide for approval of the scheduling and staffing of the audit by the auditor.
 - (a) Submit, where necessary, for review and approval the names and qualifications of personnel to be assigned to an audit.
 - (b) Consider the experience and training of the audit personnel in relation to the complexity or other requirements of the audit, and the extent of supervision to be provided.

D. DELEGATION

Policy

There is to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.

Procedures

- 1. Provide procedures for planning audits.
 - (a) Assign responsibility for planning an audit. Involve appropriate personnel assigned to the audit in the planning process.
 - (b) Develop background information or review information obtained from prior audits and update for changed circumstances.
 - (c) Describe matters to be included in the overall audit plan and the audit program, such as the following:
 - (i) Development of proposed work programs for particular areas of audit interest.
 - (ii) Determination of manpower requirements and need for specialized knowledge.
 - (iii) Development of estimates of time required to complete the audit.
 - (iv) Consideration of current economic conditions affecting the client or its industry and their potential effect on the conduct of the audit.
- 2. Provide procedures for maintaining the firm's standards of quality for the work performed.
 - (a) Provide adequate supervision at all organizational levels, considering the training, ability and experience of the personnel assigned.
 - (b) Develop guidelines for the form and content of working papers.
 - (c) Utilize standardized forms, checklists, and questionnaires to the extent appropriate to assist in the performance of audits.

- (d) Provide procedures for resolving differences of professional judgment among personnel involved in an audit.
- 3. Provide on-the-job training during the performance of audits.
 - (a) Emphasize the importance of on-the-job training as a significant part of an individual's development.
 - (i) Discuss with assistants the relationship of the work they are performing to the audit as a whole.
 - (ii) Involve assistants in as many portions of the audit as practicable.
 - (b) Emphasize the significance of personnel management skills and include coverage of these subjects in firm training programs.
 - (c) Encourage personnel to train and develop subordinates.
 - (d) Monitor assignments to determine that personnel.
 - (i) Fulfill, where applicable, the experience requirements of the relevant legislative, regulatory or professional body.
 - (ii) Gain experience in various areas of audits and varied industries.
 - (iii) Work under different supervisory personnel.

E. CONSULTATION

Policy

Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.

Procedures

- 1. Identify areas and specialized situations where consultation is required and encourage personnel to consult with or use authoritative sources on other complex or unusual matters.
 - (a) Inform personnel of the firm's consultation policies and procedures.
 - (b) Specify areas or specialized situations requiring consultation because of the nature or complexity of the subject matter. Examples include:
 - (i) Application of newly issued technical pronouncements.
 - (ii) Industries with special accounting, auditing or reporting requirements.
 - (iii) Emerging practice problems.
 - (iv) Filing requirements of legislative and regulatory bodies, particularly those of a foreign jurisdiction.

- (c) Maintain or provide access to adequate reference libraries and other authoritative sources.
 - (i) Establish responsibility for maintaining a reference library in each practice office.
 - (ii) Maintain technical manuals and issue technical pronouncements, including those relating to particular industries and other specialties.
 - (iii) Maintain consultation arrangements with other firms and individuals where necessary to supplement firm resources.
 - (iv) Refer problems to a division or group in the professional body established to deal with technical inquiries.
- 2. Designate individuals as specialists to serve as authoritative sources and define their authority in consultative situations.
 - (a) Designate individuals as specialists for filings with legislative and other regulatory bodies.
 - (b) Designate specialists for particular industries.
 - (c) Advise personnel of the degree of authority to be accorded specialists' opinions and of the procedures to be followed for resolving differences of opinion with specialists.
- 3. Specify the extent of documentation to be provided for the results of consultation in those areas and specialized situations where consultation is required.
 - (a) Advise personnel as to the extent of documentation to be prepared and the responsibility for its preparation.
 - (b) Indicate where consultation documentation is to be maintained.
 - (c) Maintain subject files containing the results of consultations for reference and research purposes.

F. ACCEPTANCE AND RETENTION OF CLIENTS

Policy

An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly and the integrity of the client's management are to be considered.

Procedures

- 1. Establish procedures for evaluation of prospective clients and for their approval as clients.
 - (a) Evaluation procedures could include the following:

- (i) Obtain and review available financial statements regarding the prospective client, such as annual reports, interim financial statements and income tax returns.
 - (ii) Inquire of third parties as to any information regarding the prospective client and its management and principals which may have a bearing on evaluating the prospective client. Inquiries may be directed to the prospective client's bankers, legal advisers, investment banker, and others in the financial or business community who may have such knowledge.
 - (iii) Communicate with the predecessor auditor. Inquiries would include questions regarding the facts that might bear on the integrity of management, on disagreements with management as to accounting policies, audit procedures, or other similarly significant matters, and on the predecessor's understanding as to the reasons for the change in auditors.
 - (iv) Consider circumstances which would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks.
 - (v) Evaluate the firm's independence and ability to serve the prospective client. In evaluating the firm's ability, consider needs for technical skills, knowledge of the industry and personnel.
 - (vi) Determine that acceptance of the client would not violate codes of professional ethics.
 - (b) Designate an individual or group, at appropriate management levels, to evaluate the information obtained regarding the prospective client and to make the acceptance decision.
 - (i) Consider types of engagements that the firm would not accept or which would be accepted only under certain conditions.
 - (ii) Provide for documentation of the conclusion reached.
 - (c) Inform appropriate personnel of the firm's policies and procedures for accepting clients.
 - (d) Designate responsibility for administering and monitoring compliance with the firm's policies and procedures for acceptance of clients.
2. Evaluate clients upon the occurrence of specified events to determine whether the relationships ought to be continued.
- (a) Events specified for this purpose could include:
 - (i) The expiration of a time period.
 - (ii) A major change in one or more of the following
 - Management

- Directors
 - Ownership
 - Legal advisers
 - Financial condition
 - Litigation status
 - Scope of the engagement
 - Nature of the client's business.
- (iii) The existence of conditions which would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.
- (b) Designate an individual or group, at appropriate management levels, to evaluate the information obtained and to make retention decisions.
- (i) Consider types of engagements that the firm would not continue or which would be continued only under certain conditions.
 - (ii) Provide for documentation of the conclusion reached.
- (c) Inform appropriate personnel of the firm's policies and procedures for retaining clients.
- (d) Designate responsibility for administering and monitoring compliance with the firm's policies and procedures for retention of clients.

G. MONITORING

Policy

The continued adequacy and operational effectiveness of quality control policies and procedures is to be monitored.

Procedures

1. Define the scope and content of the firm's monitoring program.
 - (a) Determine the monitoring procedures necessary to provide reasonable assurance that the firm's other quality control policies and procedures are operating effectively.
 - (i) Determine objectives and prepare instructions and review programs for use in conducting monitoring activities.
 - (ii) Provide guidelines for the extent of work and criteria for selection of engagements for review.
 - (iii) Establish the frequency and timing of monitoring activities.

- (iv) Establish procedures to resolve disagreements which may arise between reviewers and engagement or management personnel.
- (b) Establish levels of competence, *etc.*, for personnel to participate in monitoring activities and the method of their selection.
 - (i) Determine criteria for selecting monitoring personnel, including levels of responsibility in the firm and requirements for specialized knowledge.
 - (ii) Assign responsibility for selecting monitoring personnel.
- (c) Conduct monitoring activities.
 - (i) Review and test compliance with the firm's general quality control policies and procedures.
 - (ii) Review selected engagements for compliance with professional standards and with the firm's quality control policies and procedures.
- 2. Provide for reporting findings to the appropriate management levels, for monitoring actions taken or planned, and for overall review of the firm's quality control system.
 - (a) Discuss general findings with appropriate management personnel.
 - (b) Discuss findings on selected engagements with engagement management personnel.
 - (c) Report both general and selected engagement findings and recommendations to firm management together with corrective actions taken or planned.
 - (d) Determine that planned corrective actions were taken.
 - (e) Determine need for modification of quality control policies and procedures in view of results of monitoring activities and other relevant matters.

INTERNATIONAL STANDARD ON AUDITING 230

DOCUMENTATION

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance regarding documentation in the context of the audit of financial statements.
2. **The auditor should document matters which are important in providing evidence to support the audit opinion and evidence that the audit was carried out in accordance with ISAs.**
3. “Documentation” means the material (working papers) prepared by and for, or obtained and retained by the auditor in connection with the performance of the audit. Working papers may be in the form of data stored on paper, film, electronic media or other media.
4. Working papers:
 - (a) Assist in the planning and performance of the audit;
 - (b) Assist in the supervision and review of the audit work; and
 - (c) Record the audit evidence resulting from the audit work performed to support the auditor’s opinion.

Form and Content of Working Papers

5. **The auditor should prepare working papers which are sufficiently complete and detailed to provide an overall understanding of the audit.**
6. **The auditor should record in the working papers information on planning the audit work, the nature, timing and extent of the audit procedures performed, the results thereof, and the conclusions drawn from the audit evidence obtained.** Working papers would include the auditor’s reasoning on all significant matters which require the exercise of judgment, together with the auditor’s conclusion thereon. In areas involving difficult questions of principle or judgment, working papers will record the relevant facts that were known by the auditor at the time the conclusions were reached.
7. The extent of working papers is a matter of professional judgment since it is neither necessary nor practical to document every matter the auditor considers. In assessing the extent of working papers to be prepared and retained, it may be useful for the auditor to consider what would be necessary to provide another auditor who has no previous experience with the audit with an understanding of the work performed and the basis of the principle decisions taken but not the detailed aspects of the audit. That other auditor may only be able to obtain an understanding of detailed aspects of the audit by discussing them with the auditors who prepared the working papers.
8. The form and content of working papers are affected by matters such as the:
 - Nature of the engagement.

- Form of the auditor's report.
 - Nature and complexity of the business.
 - Nature and condition of the entity's accounting and internal control systems.
 - Needs in the particular circumstances for direction, supervision and review of work performed by assistants.
 - Specific audit methodology and technology used in the course of the audit.
9. Working papers are designed and organized to meet the circumstances and the auditor's needs for each individual audit. The use of standardized working papers (for example, checklists, specimen letters, standard organization of working papers) may improve the efficiency with which such working papers are prepared and reviewed. They facilitate the delegation of work while providing a means to control its quality.
10. To improve audit efficiency, the auditor may utilize schedules, analyses and other documentation prepared by the entity. In such circumstances, the auditor would need to be satisfied that those materials have been properly prepared.
11. Working papers ordinarily include:
- Information concerning the legal and organizational structure of the entity.
 - Extracts or copies of important legal documents, agreements and minutes.
 - Information concerning the industry, economic environment and legislative environment within which the entity operates.
 - Evidence of the planning process including audit programs and any changes thereto.
 - Evidence of the auditor's understanding of the accounting and internal control systems.
 - Evidence of inherent and control risk assessments and any revisions thereof.
 - Evidence of the auditor's consideration of the work of internal auditing and conclusions reached.
 - Analyses of transactions and balances.
 - Analyses of significant ratios and trends.
 - A record of the nature, timing and extent of audit procedures performed and the results of such procedures.
 - Evidence that the work performed by assistants was supervised and reviewed.

DOCUMENTATION

- An indication as to who performed the audit procedures and when they were performed.
 - Details of procedures applied regarding components whose financial statements are audited by another auditor.
 - Copies of communications with other auditors, experts and other third parties.
 - Copies of letters or notes concerning audit matters communicated to or discussed with the entity, including the terms of the engagement and material weaknesses in internal control.
 - Letters of representation received from the entity.
 - Conclusions reached by the auditor concerning significant aspects of the audit, including how exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
 - Copies of the financial statements and auditor's report.
12. In the case of recurring audits, some working paper files may be classified as "permanent" audit files which are updated with new information of continuing importance, as distinct from current audit files which contain information relating primarily to the audit of a single period.

Confidentiality, Safe Custody, Retention and Ownership of Working Papers

13. **The auditor should adopt appropriate procedures for maintaining the confidentiality and safe custody of the working papers and for retaining them for a period sufficient to meet the needs of the practice and in accordance with legal and professional requirements of record retention.**
14. Working papers are the property of the auditor. Although portions of or extracts from the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity's accounting records.

INTERNATIONAL STANDARD ON AUDITING 240

THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD AND ERROR IN AN AUDIT OF FINANCIAL STATEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

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Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility to consider fraud and error in an audit of financial statements. While this ISA focuses on the auditor's responsibilities with respect to fraud and error, the primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity.
2. **When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error.**

Fraud and Error and their Characteristics

3. Misstatements in the financial statements can arise from fraud or error. The term "error" refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as:
 - A mistake in gathering or processing data from which financial statements are prepared.
 - An incorrect accounting estimate arising from oversight or misinterpretation of facts.
 - A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
4. The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity.
5. Two types of intentional misstatements are relevant to the auditor's consideration of fraud—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.
6. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
 - Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
 - Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
7. Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.
8. Fraud involves motivation to commit fraud and a perceived opportunity to do so. Individuals might be motivated to misappropriate assets, for example, because the individuals are living beyond their means. Fraudulent financial reporting may be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target – particularly since the consequences to management of failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.
9. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the auditor to determine intent, particularly in matters involving management judgment, such as accounting estimates and the appropriate application of accounting principles.

Responsibility of Those Charged with Governance and of Management

10. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary by entity and from country to country. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the entity.
11. It is the responsibility of those charged with governance of an entity to ensure, through oversight of management, the integrity of an entity's accounting and

financial reporting systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with the law.

12. It is the responsibility of the management of an entity to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes implementing and ensuring the continued operation of accounting and internal control systems which are designed to prevent and detect fraud and error. Such systems reduce but do not eliminate the risk of misstatements, whether caused by fraud or error. Accordingly, management assumes responsibility for any remaining risk.

Responsibilities of the Auditor

13. As described in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. An audit conducted in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

Inherent Limitations of an Audit

14. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. An audit does not guarantee all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only reasonable assurance that material misstatements in the financial statements will be detected.
15. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency

and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those involved. Audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

16. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because those charged with governance and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist management in carrying out a fraud, with or without the employees' knowledge.
17. The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate:
 - (a) A failure to obtain reasonable assurance,
 - (b) Inadequate planning, performance or judgment,
 - (c) The absence of professional competence and due care, or,
 - (d) A failure to comply with ISAs.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with ISAs is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.

Professional Skepticism

18. The auditor plans and performs an audit with an attitude of professional skepticism in accordance with ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," (paragraph 6). Such an attitude is necessary for the auditor to identify and properly evaluate, for example:
 - Matters that increase the risk of a material misstatement in the financial statements resulting from fraud or error (for example, management's

characteristics and influence over the control environment, industry conditions, and operating characteristics and financial stability).

- Circumstances that make the auditor suspect that the financial statements are materially misstated.
 - Evidence obtained (including the auditor's knowledge from previous audits) that brings into question the reliability of management representations.
19. However, unless the audit reveals evidence to the contrary, the auditor is entitled to accept records and documents as genuine. Accordingly, an audit performed in accordance with ISAs rarely contemplates authentication of documentation, nor are auditors trained as, or expected to be, experts in such authentication.

Planning Discussions

20. **In planning the audit, the auditor should discuss with other members of the audit team the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error.**
21. Such discussions would involve considering, for example, in the context of the particular entity, where errors may be more likely to occur or how fraud might be perpetrated. Based on these discussions, members of the audit team may gain a better understanding of the potential for material misstatements in the financial statements resulting from fraud or error in the specific areas of the audit assigned to them, and how the results of the audit procedures that they perform may affect other aspects of the audit. Decisions may also be made on which members of the audit team will conduct certain inquiries or audit procedures, and how the results of those inquiries and procedures will be shared.

Inquiries of Management

22. **When planning the audit, the auditor should make inquiries of management:**
- (a) **To obtain an understanding of:**
 - (i) **Management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and**
 - (ii) **The accounting and internal control systems management has put in place to address such risk;**
 - (b) **To obtain knowledge of management's understanding regarding the accounting and internal control systems in place to prevent and detect error;**

- (c) **To determine whether management is aware of any known fraud that has affected the entity or suspected fraud that the entity is investigating; and**
 - (d) **To determine whether management has discovered any material errors.**
- 23. The auditor supplements the auditor's own knowledge of the entity's business by making inquiries of management regarding management's own assessment of the risk of fraud and the systems in place to prevent and detect it. In addition, the auditor makes inquiries of management regarding the accounting and internal control systems in place to prevent and detect error. Since management is responsible for the entity's accounting and internal control systems and for the preparation of the financial statements, it is appropriate for the auditor to inquire of management how it is discharging these responsibilities. Matters that might be discussed as part of these inquiries include:
 - (a) Whether there are particular subsidiary locations, business segments, types of transactions, account balances or financial statement categories where the possibility of error may be high, or where fraud risk factors may exist, and how they are being addressed by management;
 - (b) The work of the entity's internal audit function and whether internal audit has identified fraud or any serious weaknesses in the system of internal control; and
 - (c) How management communicates to employees its view on responsible business practices and ethical behavior, such as through ethics policies or codes of conduct.
- 24. The nature, extent and frequency of management's assessment of such systems and risk vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less formal and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may be indicative of the lack of importance that management places on internal control.
- 25. It is also important that the auditor obtain an understanding of the design of the accounting and internal control systems within the entity. In designing such systems, management makes informed judgments on the nature and extent of the control procedures it chooses to implement and the nature and extent of the risks it chooses to assume. As a result of making these inquiries of management, the auditor may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties. Information from these inquiries may also be useful in identifying fraud

risk factors that may affect the auditor's assessment of the risk that the financial statements may contain material misstatements caused by fraud.

26. It is also important for the auditor to inquire about management's knowledge of frauds that have affected the entity, suspected frauds that are being investigated, and material errors that have been discovered. Such inquiries might indicate possible weaknesses in control procedures if, for example, a number of errors have been found in certain areas. Alternatively, such inquiries might indicate that control procedures are operating effectively because anomalies are being identified and investigated promptly.
27. Although the auditor's inquiries of management may provide useful information concerning the risk of material misstatements in the financial statements resulting from employee fraud, such inquiries are unlikely to provide useful information regarding the risk of material misstatements in the financial statements resulting from management fraud. Accordingly, the auditor's follow-up of fraud risk factors, as discussed in paragraph 39, is of particular relevance in relation to management fraud.

Discussions with Those Charged with Governance

28. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of how management has discharged its responsibilities. In such circumstances, auditors are encouraged to seek the views of those charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect fraud and error, the risk of fraud and error, and the competence and integrity of management. Such inquiries may provide insights regarding the susceptibility of the entity to management fraud, for example. The auditor may have an opportunity to seek the views of those charged with governance during, for example, a meeting with those charged with governance to discuss the general approach and overall scope of the audit. This discussion may also provide those charged with governance with the opportunity to bring matters of concern to the auditor's attention.
29. Since the responsibilities of those charged with governance and management may vary by entity and from country to country, it is important that the auditor understand the nature of these responsibilities within an entity to ensure that the inquiries and communications described above are directed to the appropriate individuals.¹
30. In addition, following the inquiries of management described in paragraphs 22–27, the auditor considers whether there are any matters of governance

¹ ISA 260, "Communication of Audit Matters with Those Charged with Governance," paragraph 8 discusses with whom the auditor communicates when the entity's governance structure is not well defined.

interest to be discussed with those charged with governance of the entity.² Such matters may include for example:

- Concerns about the nature, extent and frequency of management's assessments of the accounting and control systems in place to prevent and detect fraud and error, and of the risk that the financial statements may be misstated.
- A failure by management to address appropriately material weaknesses in internal control identified during the prior period's audit.
- The auditor's evaluation of the entity's control environment, including questions regarding management competence and integrity.
- The effect of any matters, such as those above, on the general approach and overall scope of the audit, including additional procedures the auditor may need to perform.

Audit Risk

31. ISA 400, "Risk Assessments and Internal Control," paragraph 3 states that "audit risk" is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Such misstatements can result from either fraud or error. ISA 400 identifies the three components of audit risk and provides guidance on how to assess these risks: inherent risk, control risk and detection risk.

Inherent Risk and Control Risk

32. **When assessing inherent risk and control risk in accordance with ISA 400, "Risk Assessments and Internal Control," the auditor should consider how the financial statements might be materially misstated as a result of fraud or error. In considering the risk of material misstatement resulting from fraud, the auditor should consider whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets.**
33. ISA 400 describes the auditor's assessment of inherent risk and control risk, and how those assessments affect the nature, timing and extent of the audit procedures. In making those assessments, the auditor considers how the financial statements might be materially misstated as a result of fraud or error.
34. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, using the auditor's knowledge of the business, the auditor may identify events or conditions that provide an opportunity, a motive or a means to commit fraud, or indicate that fraud may already have occurred. Such events or conditions are referred to as "fraud risk factors". For example, a document

² For a discussion of these matters, see ISA 260, "Communication of Audit Matters with Those Charged with Governance," paragraphs 11–12.

may be missing, a general ledger may be out of balance, or an analytical procedure may not make sense. However, these conditions may be the result of circumstances other than fraud. Therefore, fraud risk factors do not necessarily indicate the existence of fraud, however, they often have been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of inherent risk or control risk. Examples of fraud risk factors are set out in Appendix 1 to this ISA.

35. Fraud risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk.
36. Although the fraud risk factors described in Appendix 1 cover a broad range of situations typically faced by auditors, they are only examples. Moreover, not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances. Accordingly, the auditor uses professional judgment when assessing the significance and relevance of fraud risk factors and determining the appropriate audit response.
37. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of those charged with governance, and the internal audit function. The auditor also considers what steps have been taken to enforce a formal code of conduct, and the effectiveness of the budgeting system. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity might not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level.
38. The presence of fraud risk factors may indicate that the auditor will be unable to assess control risk at less than high for certain financial statement assertions. On the other hand, the auditor may be able to identify internal controls designed to mitigate those fraud risk factors that the auditor can test to support a control risk assessment below high.

Detection Risk

39. **Based on the auditor's assessment of inherent and control risks (including the results of any tests of controls), the auditor should design substantive procedures to reduce to an acceptably low level the risk that misstatements resulting from fraud and error that are material to the financial statements taken as a whole will not be detected. In designing the substantive procedures, the auditor should address the fraud risk factors that the auditor has identified as being present.**
40. ISA 400, explains that the auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk to an acceptably low level. In designing substantive procedures, the auditor addresses fraud risk factors that the auditor has identified as being present. The auditor's response to those factors is influenced by their nature and significance. In some cases, even though fraud risk factors have been identified as being present, the auditor's judgment may be that the audit procedures, including both tests of control, and substantive procedures, already planned, are sufficient to respond to the fraud risk factors.
41. In other circumstances, the auditor may conclude that there is a need to modify the nature, timing and extent of substantive procedures to address fraud risk factors present. In these circumstances, the auditor considers whether the assessment of the risk of material misstatement calls for an overall response, a response that is specific to a particular account balance, class of transactions or assertion, or both types of response. The auditor considers whether changing the nature of audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors. Examples of response procedures are set out in Appendix 2 to this ISA, including examples of responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.

Procedures when Circumstances Indicate a Possible Misstatement

42. **When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.**
43. During the course of the audit, the auditor may encounter circumstances that indicate that the financial statements may contain a material misstatement resulting from fraud or error. Examples of such circumstances that, individually or in combination, may make the auditor suspect that such a misstatement exists are set out in Appendix 3 to this ISA.
44. When the auditor encounters such circumstances, the nature, timing and extent of the procedures to be performed depends on the auditor's judgment as to the

type of fraud or error indicated, the likelihood of its occurrence, and the likelihood that a particular type of fraud or error could have a material effect on the financial statements. Ordinarily, the auditor is able to perform sufficient procedures to confirm or dispel a suspicion that the financial statements are materially misstated resulting from fraud or error. If not, the auditor considers the effect on the auditor's report, as discussed in paragraph 48.

45. The auditor cannot assume that an instance of fraud or error is an isolated occurrence and therefore, before the conclusion of the audit, the auditor considers whether the assessment of the components of audit risk made during the planning of the audit may need to be revised and whether the nature, timing and extent of the auditor's other procedures may need to be reconsidered (see ISA 400 paragraphs 39 and 46). For example, the auditor considers:
 - The nature, timing and extent of substantive procedures.
 - The assessment of the effectiveness of internal controls if control risk was assessed below high.
 - The assignment of audit team members that may be appropriate in the circumstances.

Considering Whether an Identified Misstatement may be Indicative of Fraud

46. **When the auditor identifies a misstatement, the auditor should consider whether such a misstatement may be indicative of fraud and if there is such an indication, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.**
47. If the auditor has determined that a misstatement is, or may be, the result of fraud, the auditor evaluates the implications, especially those dealing with the organizational position of the person or persons involved. For example, fraud involving misappropriations of cash from a small petty cash fund is ordinarily of little significance to the auditor in assessing the risk of material misstatement due to fraud. This is because both the manner of operating the fund and its size tend to establish a limit on the amount of potential loss, and the custodianship of such funds is ordinarily entrusted to an employee with a low level of authority. Conversely, when the matter involves management with a higher level of authority, even though the amount itself is not material to the financial statement, it may be indicative of a more pervasive problem. In such circumstances, the auditor reconsiders the reliability of evidence previously obtained since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence. If management, particularly at the highest level, is

involved in fraud, the auditor may not be able to obtain the evidence necessary to complete the audit and report on the financial statements.

Evaluation and Disposition of Misstatements, and the Effect on the Auditor's Report

48. **When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud or error, the auditor should consider the implications for the audit.** ISA 320, "Audit Materiality," paragraphs 12–16, and ISA 700, "The Auditor's Report on Financial Statements," paragraphs 36–46, provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's report.

Documentation

49. **The auditor should document fraud risk factors identified as being present during the auditor's assessment process (see paragraph 32) and document the auditor's response to any such factors (see paragraph 39). If during the performance of the audit, fraud risk factors are identified that cause the auditor to believe that additional audit procedures are necessary, the auditor should document the presence of such risk factors and the auditor's response to them.**
50. ISA 230, "Documentation," requires the auditor to document matters which are important in providing evidence to support the audit opinion, and states that the working papers include the auditor's reasoning on all significant matters which require the auditor's judgment, together with the auditor's conclusion thereon. Because of the importance of fraud risk factors in the assessment of the inherent or control risk of material misstatement, the auditor documents fraud risk factors identified and the response considered appropriate by the auditor.

Management Representations

51. **The auditor should obtain written representations from management that:**
- (a) **It acknowledges its responsibility for the implementation and operations of accounting and internal control systems that are designed to prevent and detect fraud and error;**
 - (b) **It believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;**
 - (c) **It has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and**

- (d) **It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.**
52. ISA 580, “Management representations,” provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that management acknowledges its responsibility for the accounting and internal control systems designed to prevent and detect fraud and error.
53. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtain written representation from management that any uncorrected misstatements resulting from either fraud or error are, in management’s opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, “We do not agree that items ... and ... constitute misstatements because [*description of reasons*].”
54. The auditor may designate an amount below which misstatements need not be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. In so doing, the auditor considers the fact that the determination of materiality involves qualitative as well as quantitative considerations and that misstatements of a relatively small amount could nevertheless have a material effect on the financial statements. The summary of uncorrected misstatements included in or attached to the written representation need not include such misstatements.
55. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management confirming that it has disclosed to the auditor all facts relating to any frauds or suspected frauds that it is aware of that may have affected the entity, and that management has disclosed to the auditor the results of management’s assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Communication

56. **When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, or error, the auditor should consider the auditor’s responsibility to communicate that information to management, those charged with governance and, in some circumstances, to regulatory and enforcement authorities.**

57. Communication of a misstatement resulting from fraud, or a suspected fraud, or error to the appropriate level of management on a timely basis is important because it enables management to take action as necessary. The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the nature, magnitude and frequency of the misstatement or suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the misstatement or suspected fraud.
58. The determination of which matters are to be communicated by the auditor to those charged with governance is a matter of professional judgment and is also affected by any understanding between the parties as to which matters are to be communicated. Ordinarily, such matters include:
- Questions regarding management competence and integrity.
 - Fraud involving management.
 - Other fraud that results in a material misstatement of the financial statements.
 - Material misstatements resulting from error.
 - Misstatements that indicate material weaknesses in internal control, including the design or operation of the entity's financial reporting process.
 - Misstatements that may cause future financial statements to be materially misstated.

Communication of Misstatements Resulting from Error to Management and To Those Charged with Governance

59. **If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260, "Communication of Audit Matters with Those Charged with Governance."**
60. **The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.**
61. As noted in paragraph 54, the uncorrected misstatements communicated to those charged with governance need not include the misstatements below a designated amount.

Communication of Misstatements Resulting from Fraud to Management and To Those Charged with Governance

62. **If the auditor has:**

- (a) **Identified a fraud, whether or not it results in a material misstatement in the financial statements; or**
- (b) **Obtained evidence that indicates that fraud may exist (even if the potential effect on the financial statements would not be material);**

the auditor should communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance in accordance with ISA 260, “Communication of Audit Matters with Those Charged with Governance.”

63. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of an appropriate level of management. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity’s organization). The determination of which level of management is the appropriate one is also affected in these circumstances by the likelihood of collusion or the involvement of a member of management.
64. If the auditor has determined that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor:
- (a) Discusses the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved, and with management at the highest level; and
 - (b) If appropriate, suggests that management consult with legal counsel.

Communication of Material Weaknesses in Internal Control

65. **The auditor should communicate to management any material weaknesses in internal control related to the prevention or detection of fraud and error, which have come to the auditor’s attention as a result of the performance of the audit. The auditor should also be satisfied that those charged with governance have been informed of any material weaknesses in internal control related to the prevention and detection of fraud that either have been brought to the auditor’s attention by management or have been identified by the auditor during the audit.**
66. When the auditor has identified any material weaknesses in internal control related to the prevention or detection of fraud or error, the auditor communicates these material weaknesses in internal control to management. Because of the serious implications of material weaknesses in internal control

related to the prevention and detection of fraud, it is also important that such deficiencies be brought to the attention of those charged with governance.

67. If the integrity or honesty of management or those charged with governance are doubted, the auditor ordinarily considers seeking legal advice to assist in the determination of the appropriate course of action.

Communications to Regulatory and Enforcement Authorities

68. The auditor's professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud and error to a party outside the client entity. However, the auditor's legal responsibilities vary by country and in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. For example, in some countries, the auditor of a financial institution has a statutory duty to report the occurrence of fraud and material error to supervisory authorities. The auditor considers seeking legal advice in such circumstances.

Auditor Unable to Complete the Engagement

69. **If the auditor concludes that it is not possible to continue performing the audit as a result of a misstatement resulting from fraud or suspected fraud, the auditor should:**
- (a) **Consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;**
 - (b) **Consider the possibility of withdrawing from the engagement; and**
 - (c) **If the auditor withdraws:**
 - (i) **Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and**
 - (ii) **Consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.**
70. The auditor may encounter exceptional circumstances that bring into question the auditor's ability to continue performing the audit, for example, in circumstances where:
- (a) The entity does not take the remedial action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

- (b) The auditor's consideration of the risk of material misstatement resulting from fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
 - (c) The auditor has significant concern about the competence or integrity of management or those charged with governance.
71. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of continuing association with the entity.
 72. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by country. In some countries, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action.

Communication with a Proposed Successor Auditor

73. **As stated in the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants (the Code), on receipt of an inquiry from a proposed successor auditor, the existing auditor should advise whether there are any professional reasons why the proposed successor auditor should not accept the appointment. If the client denies the existing auditor permission to discuss its affairs with the proposed successor auditor or limits what the existing auditor may say, that fact should be disclosed to the proposed successor auditor.**
74. The auditor may be contacted by a proposed successor auditor inquiring whether there are any professional reasons why the proposed successor auditor should not accept the appointment. The responsibilities of existing and proposed successor auditors are set out in some detail in the Code; however, the professional and legal responsibilities of each auditor may vary by country.
75. The extent to which an existing auditor can discuss the affairs of a client with a proposed successor auditor will depend on whether the existing auditor has obtained the client's permission to do so, and on the professional and legal responsibilities in each country relating to such disclosure. Subject to any constraints arising from these responsibilities, the existing auditor advises the proposed successor auditor whether there are any professional reasons not to accept the appointment, providing details of the information and discussing freely with the proposed successor auditor all matters relevant to the appointment. If fraud or suspected fraud was a factor in the existing auditor's

withdrawal from the engagement, it is important that the existing auditor take care to state only the facts (not his or her conclusions) relating to these matters.

Effective Date

76. This ISA is effective for audits of financial statements for periods ending on or after June 30, 2002. Early application of the provisions of this ISA is permissible.

Public Sector Perspective

1. *The Public Sector Committee (PSC) considers and makes use of the pronouncements issued by the International Auditing Practices Committee for their application in the public sector. "Public sector" refers to national governments, regional (state, provincial, territorial) governments, local (city, town) governments and related governmental entities (agencies, boards, commissions and enterprises).*
2. *Irrespective of whether an assurance engagement is being conducted in the private or public sectors, the basic principles remain the same. However, the application of the principles may need to be clarified or supplemented to accommodate the public sector circumstances and perspective of individual jurisdictions.*
3. *In respect of paragraph 2 of this ISA, it has to be noted that the nature and the scope of the public sector audit may be affected by legislation, regulation, ordinances and ministerial directives relating to the detection of fraud and error. In addition to any formally mandated responsibility to detect fraud, the use of public funds tends to impose a higher profile on fraud issues, and auditors may need to be responsive to public expectations regarding detection of fraud. Public expectations regarding the use of public funds will often mean that a public sector auditor will need to consider what action to take in relation to the fraud, even though the fraud may not be material to the financial statements or affect the auditor's report on the financial statements.*
4. *Paragraphs 56–68 set out the communication responsibilities to management and those charged with governance. In the public sector, the auditor may have additional responsibilities because of specific provisions of the audit mandate or related legislation or regulation. Examples of such specific provisions may include requirements to report instances where public monies have not been expended for the purposes for which they were appropriated.*
5. *Paragraphs 69–72 outline the issues an auditor should consider if the auditor concludes that it is not possible to continue the audit. In the public sector, the responsibilities of the auditor are usually set out in legislation and the auditor may not have the option to withdraw from the engagement. In such situations the auditor will need to consider the impact on the audit report and any requirements to report to other parties, including those persons charged with governance. For public sector auditors, the auditor's written communications*

may be placed on public record and, therefore, their written communications may be distributed to a wider audience than solely those persons charged with governance of the entity.

6. *Paragraphs 73–75 set out the requirements concerning communication with a proposed successor auditor. These provisions may have limited application in the public sector where the auditor’s appointment and termination of audit engagements may be subject to a separate legislative regime.*

Appendix 1

Examples of Risk Factors Relating to Misstatements Resulting from Fraud

The fraud risk factors identified in this Appendix are examples of such factors typically faced by auditors in a broad range of situations. However, the fraud risk factors listed below are only examples; not all of these factors are likely to be present in all audits, nor is the list necessarily complete. Furthermore, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk. Fraud risk factors are discussed in paragraphs 34–38.

Fraud Risk Factors Relating to Misstatements Resulting from Fraudulent Financial Reporting

Fraud risk factors that relate to misstatements resulting from fraudulent financial reporting may be grouped in the following three categories:

1. Management's Characteristics and Influence over the Control Environment.
2. Industry Conditions.
3. Operating Characteristics and Financial Stability.

For each of these three categories, examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting are set out below.

1. *Fraud Risk Factors Relating to Management's Characteristics and Influence over the Control Environment*

These fraud risk factors pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.

- There is motivation for management to engage in fraudulent financial reporting. Specific indicators might include the following:
 - A significant portion of management's compensation is represented by bonuses, stock options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow.
 - There is excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
 - Management commits to analysts, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts.
 - Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.

- There is a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include the following:
 - Management does not effectively communicate and support the entity's values or ethics, or management communicates inappropriate values or ethics.
 - Management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.
 - Management does not monitor significant controls adequately.
 - Management fails to correct known material weaknesses in internal control on a timely basis.
 - Management sets unduly aggressive financial targets and expectations for operating personnel.
 - Management displays a significant disregard for regulatory authorities.
 - Management continues to employ ineffective accounting, information technology or internal auditing staff.
- Non-financial management participates excessively in, or is preoccupied with, the selection of accounting principles or the determination of significant estimates.
- There is a high turnover of management, counsel or board members.
- There is a strained relationship between management and the current or predecessor auditor. Specific indicators might include the following:
 - Frequent disputes with the current or a predecessor auditor on accounting, auditing or reporting matters.
 - Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - Formal or informal restrictions on the auditor that inappropriately limit the auditor's access to people or information, or limit the auditor's ability to communicate effectively with those charged with governance.
 - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.
- There is a history of securities law violations, or claims against the entity or its management alleging fraud or violations of securities laws.

- The corporate governance structure is weak or ineffective, which may be evidenced by, for example:
 - A lack of members who are independent of management.
 - Little attention being paid to financial reporting matters and to the accounting and internal control systems by those charged with governance.

2. *Fraud Risk Factors Relating to Industry Conditions*

These fraud risk factors involve the economic and regulatory environment in which the entity operates.

- New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity.
- A high degree of competition or market saturation, accompanied by declining margins.
- A declining industry with increasing business failures and significant declines in customer demand.
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

3. *Fraud Risk Factors Relating to Operating Characteristics and Financial Stability*

These fraud risk factors pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures).
- Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity (for example, the ultimate collectibility of receivables, the timing of revenue recognition, the realizability of financial instruments based on highly-subjective valuation of collateral or difficult-to-assess repayment sources, or a significant deferral of costs).
- Significant related party transactions which are not in the ordinary course of business.

- Significant related party transactions which are not audited or are audited by another firm.
- Significant, unusual or highly complex transactions (especially those close to year-end) that pose difficult questions concerning substance over form.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority or contractual arrangements without apparent business purpose.
- Difficulty in determining the organization or person (or persons) controlling the entity.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to changes in interest rates.
- Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- A threat of imminent bankruptcy, foreclosure or hostile takeover.
- Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported.
- A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Fraud Risk Factors Relating to Misstatements Resulting from Misappropriation of Assets

Fraud risk factors that relate to misstatements resulting from misappropriation of assets may be grouped in the following two categories:

1. Susceptibility of Assets to Misappropriation.
2. Controls.

For each of these two categories, examples of fraud risk factors relating to misstatements resulting from misappropriation of assets are set out below. The extent of the auditor's consideration of the fraud risk factors in category 2 is influenced by the degree to which fraud risk factors in category 1 are present.

1. *Fraud Risk Factors Relating to Susceptibility of Assets to Misappropriation*

These fraud risk factors pertain to the nature of an entity's assets and the degree to which they are subject to theft.

- Large amounts of cash on hand or processed.
- Inventory characteristics, such as small size combined with high value and high demand.
- Easily convertible assets, such as bearer bonds, diamonds or computer chips.
- Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.

2. *Fraud Risk Factors Relating to Controls*

These fraud risk factors involve the lack of controls designed to prevent or detect misappropriation of assets.

- Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations).
- Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation.
- Inadequate record keeping for assets susceptible to misappropriation.
- Lack of an appropriate segregation of duties or independent checks.
- Lack of an appropriate system of authorization and approval of transactions (for example, in purchasing).
- Poor physical safeguards over cash, investments, inventory or fixed assets.
- Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns).
- Lack of mandatory vacations for employees performing key control functions.

Appendix 2

Examples of Modifications of Procedures in Response to the Assessment of Fraud Risk Factors in Accordance with Paragraphs 39–41

The following are examples of possible responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets. The auditor exercises judgment to select the most appropriate procedures in the circumstances. The procedures identified may not be the most appropriate nor necessary in each circumstance. The auditor's response to fraud risk factors is discussed in paragraphs 40–41.

Overall Considerations

Judgments about the risk of material misstatements resulting from fraud may affect the audit in the following ways:

- Professional skepticism. The application of professional skepticism may include: (i) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (ii) increased recognition of the need to corroborate management explanations or representations concerning material matters.
- Assignment of members of the audit team. The knowledge, skill and ability of members of the audit team assigned significant audit responsibilities need to be commensurate with the auditor's assessment of the level of risk for the engagement. In addition, the extent of supervision needs to recognize the risk of material misstatement resulting from fraud and the qualifications of members of the audit team performing the work.
- Accounting principles and policies. The auditor may decide to consider further management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation or capitalizing versus expensing.
- Controls. The auditor's ability to assess control risk below high may be reduced. However, this does not eliminate the need for the auditor to obtain an understanding of the components of the entity's internal control sufficient to plan the audit. In fact, such an understanding may be of particular importance in further understanding and considering any controls (or lack thereof) the entity has in place to address the fraud risk factors identified. However, this consideration also needs to include an added sensitivity to management's ability to override such controls.

The nature, timing and extent of procedures may need to be modified in the following ways:

- The nature of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For

example, more audit evidence may be needed from independent sources outside the entity.

- The timing of substantive procedures may need to be altered to be closer to, or at, year-end. For example, if there are unusual incentives for management to engage in fraudulent financial reporting, the auditor might conclude that substantive procedures should be performed near or at year-end because it would not be possible to control the incremental audit risk associated with that fraud risk factor.
- The extent of the procedures applied will need to reflect the assessment of the risk of material misstatement resulting from fraud. For example, increased sample sizes or more extensive analytical procedures may be appropriate.

The auditor considers whether changing the nature of the audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors.

Considerations at the Account Balance, Class of Transactions and Assertion Level

Specific responses to the auditor's assessment of the risk of material misstatement resulting from fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the account balances, classes of transactions and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas will need to be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the fraud risk factors or conditions identified.

The following are specific examples of responses:

- Visit locations or perform certain tests on a surprise or unannounced basis. For example, observe inventory at locations where auditor attendance has not been previously announced or count cash at a particular date on a surprise basis.
- Request that inventories be counted at a date closer to the year-end.
- Alter the audit approach in the current year. For example, contact major customers and suppliers orally in addition to sending written confirmation, send confirmation requests to a specific party within an organization, or seek more and different information.
- Perform a detailed review of the entity's quarter-end or year-end adjusting entries and investigate any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigate the possibility of related parties and the sources of financial resources supporting the transactions.
- Perform substantive analytical procedures at a detailed level. For example, compare sales and cost of sales by location and line of business to expectations developed by the auditor.

- Conduct interviews of personnel involved in areas for which there is a concern about the risk of material misstatement resulting from fraud, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, consider discussing with them the extent of work necessary to be performed to ensure that the risk of material misstatement resulting from fraud resulting from transactions and activities among these components is adequately addressed.
- If the work of an expert becomes particularly significant with respect a financial statement item for which the risk of misstatement due to fraud is high, perform additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engage another expert for that purpose.
- Perform audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Perform procedures on account or other reconciliations prepared by the entity, including consideration of reconciliations performed at interim periods.
- Perform computer-assisted techniques, such as data mining to test for anomalies in a population.
- Test the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses—Misstatements Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risk of material misstatements resulting from fraudulent financial reporting are as follows:

- Revenue recognition. If there is a risk of material misstatement resulting from fraud that may involve or result in improper revenue recognition, it may be appropriate to confirm with customers certain relevant contract terms and the absence of side agreements, inasmuch as the appropriate accounting is often influenced by such terms or agreements.
- Inventory quantities. If there is a risk of material misstatement resulting from fraud relating to inventory quantities, reviewing the entity's inventory records may help to identify locations, areas or items for specific attention during or after the physical inventory count. Such a review may lead, for example, to a decision to observe inventory counts at certain locations on an unannounced basis, or to ask management to ensure that counts at all locations subject to count are performed on the same date.

- Non-standard journal entries. If there is a risk of material misstatements resulting from fraudulent financial reporting, performing tests of non-standard journal entries to confirm that they are adequately supported and reflect underlying events and transactions may help in identifying fictitious entries of aggressive recognition practices. While there is not generally accepted definition of non-standard journal entries, in general, they are financial statement changes or entries made in the books and records (including computer records) of an entity that usually are initiated by management-level personnel and are not routine or associated with the normal processing of transactions.

Specific Responses—Misstatements Resulting from Misappropriations of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement resulting from fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions.

Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified. For example, where a particular asset is highly susceptible to misappropriation that is potentially material to the financial statements, it may be useful for the auditor to obtain an understanding of the control procedures related to the prevention and detection of such misappropriation and to test the operating effectiveness of such controls.

Appendix 3

Examples of Circumstances that Indicate the Possibility of Fraud or Error

The auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial statements may contain a material misstatement resulting from fraud or error. The circumstances listed below are only examples; not all of these circumstances are likely to be present in all audits, nor is the list necessarily complete. Circumstances that indicate a possible misstatement are discussed in paragraphs 43-44.

- Unrealistic time deadlines for audit completion imposed by management.
- Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers.
- Limitation in audit scope imposed by management.
- Identification of important matters not previously disclosed by management.
- Significant difficult-to-audit figures in the accounts.
- Aggressive application of accounting principles.
- Conflicting or unsatisfactory evidence provided by management or employees.
- Unusual documentary evidence such as handwritten alterations to documentation, or handwritten documentation which is ordinarily electronically printed.
- Information provided unwillingly or after unreasonable delay.
- Seriously incomplete or inadequate accounting records.
- Unsupported transactions.
- Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year end.
- Transactions not recorded in accordance with management's general or specific authorization.
- Significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.
- Inadequate control over computer processing (for example, too many processing errors; delays in processing results and reports).
- Significant differences from expectations disclosed by analytical procedures.
- Fewer confirmation responses than expected or significant differences revealed by confirmation responses.
- Evidence of an unduly lavish lifestyle by officers or employees.

THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD AND ERROR

- Unreconciled suspense accounts.
- Long outstanding account receivable balances.

ISA 200 “OBJECTIVE AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF FINANCIAL STATEMENTS”

Replace the existing paragraph ISA 200.6 with the following:

The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of overgeneralizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

INTERNATIONAL STANDARD ON AUDITING 250

CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility to consider laws and regulations in an audit of financial statements.
2. **When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements.** However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.
3. The term "noncompliance" as used in this ISA refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts, include transactions entered into by, or in the name of, the entity or on its behalf by its management or employees. For the purpose of this ISA, noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity's management or employees.
4. Whether an act constitutes noncompliance is a legal determination that is ordinarily beyond the auditor's professional competence. The auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute noncompliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute noncompliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.
5. Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statements or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are only subject to the many laws and regulations that generally relate to the operating aspects of the business (such as those related to occupational safety and health and equal employment). Noncompliance with laws and regulations could result in financial consequences for the entity such as fines, litigation, *etc.* Generally, the further removed noncompliance is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of it or to recognize its possible noncompliance.

6. Laws and regulations vary from country to country. National accounting and auditing standards are therefore likely to be more specific as to the relevance of laws and regulations to an audit.
7. This ISA applies to audits of financial statements and does not apply to other engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.
8. Guidance on the auditor's responsibility to consider fraud and errors in an audit of financial statements is provided in ISA 240 "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements."

Responsibility of Management for the Compliance with Laws and Regulations

9. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management.
10. The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of noncompliance:
 - Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
 - Instituting and operating appropriate systems of internal control.
 - Developing, publicizing and following a Code of Conduct.
 - Ensuring employees are properly trained and understand the Code of Conduct.
 - Monitoring compliance with the Code of Conduct and acting appropriately to discipline employees who fail to comply with it.
 - Engaging legal advisors to assist in monitoring legal requirements.
 - Maintaining a register of significant laws with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to:

- An internal audit function.
- An audit committee.

The Auditor's Consideration of Compliance with Laws and Regulations

11. The auditor is not, and cannot be held responsible for preventing noncompliance. The fact that an annual audit is carried out may, however, act as a deterrent.

12. An audit is subject to the unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. This risk is higher with regard to material misstatements resulting from noncompliance with laws and regulations due to factors such as:
 - There are many laws and regulations, relating principally to the operating aspects of the entity, that typically do not have a material effect on the financial statements and are not captured by the accounting and internal control systems.
 - The effectiveness of audit procedures is affected by the inherent limitations of the accounting and internal control systems and by the use of testing.
 - Much of the evidence obtained by the auditor is persuasive rather than conclusive in nature.
 - Noncompliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, senior management override of controls or intentional misrepresentations being made to the auditor.
13. **In accordance with ISA 200 “Objective and General Principles Governing an Audit of Financial Statements,” the auditor should plan and perform the audit with an attitude of professional skepticism recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations.**
14. In accordance with specific statutory requirements, the auditor may be specifically required to report as part of the audit of the financial statements whether the entity complies with certain provisions of laws or regulations. In these circumstances, the auditor would plan to test for compliance with these provisions of the laws and regulations.
15. **In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework.**
16. In obtaining this general understanding, the auditor would particularly recognize that some laws and regulations may have a fundamental effect on the operations of the entity. That is, noncompliance with certain laws and regulations may cause the entity to cease operations, or call into question the entity’s continuance as a going concern. For example, noncompliance with the requirements of the entity’s license or other title to perform its operations could have such an impact (for example, for a bank, noncompliance with capital or investment requirements).
17. To obtain the general understanding of laws and regulations, the auditor would ordinarily:

- Use the existing knowledge of the entity's industry and business.
 - Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations.
 - Inquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity.
 - Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments.
 - Discuss the legal and regulatory framework with auditors of subsidiaries in other countries (for example, if the subsidiary is required to adhere to the securities regulations of the parent company).
18. **After obtaining the general understanding, the auditor should perform procedures to help identify instances of noncompliance with those laws and regulations where noncompliance should be considered when preparing financial statements, specifically:**
- (a) **Inquiring of management as to whether the entity is in compliance with such laws and regulations.**
 - (b) **Inspecting correspondence with the relevant licensing or regulatory authorities.**
19. **Further, the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.**
20. Such laws and regulations would be well established and known to the entity and within the industry; they would be considered on a recurring basis each time financial statements are issued. These laws and regulations, may relate, for example, to the form and content of financial statements, including industry specific requirements; accounting for transactions under government contracts; or the accrual or recognition of expenses for income taxes or pension costs.
21. Other than as described in paragraphs 18, 19 and 20, the auditor does not test or perform other procedures on the entity's compliance with laws and regulations since this would be outside the scope of an audit of financial statements.
22. **The auditor should be alert to the fact that procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible noncompliance with laws and regulations to the auditor's attention.** For example, such procedures include reading minutes;

inquiring of the entity's management and legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of transactions or balances.

23. **The auditor should obtain written representations that management has disclosed to the auditor all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing financial statements.**
24. In the absence of evidence to the contrary, the auditor is entitled to assume the entity is in compliance with these laws and regulations.

Procedures When Noncompliance is Discovered

25. The Appendix to this ISA sets out examples of the type of information that might come to the auditor's attention that may indicate noncompliance.
26. **When the auditor becomes aware of information concerning a possible instance of noncompliance, the auditor should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements.**
27. When evaluating the possible effect on the financial statements, the auditor considers:
 - The potential financial consequences, such as fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation.
 - Whether the potential financial consequences require disclosure.
 - Whether the potential financial consequences are so serious as to call into question the true and fair view (fair presentation) given by the financial statements.
28. **When the auditor believes there may be noncompliance, the auditor should document the findings and discuss them with management.** Documentation of findings would include copies of records and documents and making minutes of conversations, if appropriate.
29. If management does not provide satisfactory information that it is in fact in compliance, the auditor would consult with the entity's lawyer about the application of the laws and regulations to the circumstances and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's lawyer or when the auditor is not satisfied with the opinion, the auditor would consider consulting the auditor's own lawyer as to whether a violation of a law or regulation is involved, the possible legal consequences and what further action, if any, the auditor would take.

30. **When adequate information about the suspected noncompliance cannot be obtained, the auditor should consider the effect of the lack of audit evidence on the auditor's report.**
31. **The auditor should consider the implications of noncompliance in relation to other aspects of the audit, particularly the reliability of management representations.** In this regard, the auditor reconsiders the risk assessment and the validity of management representations, in case of noncompliance not detected by internal controls or not included in management representations. The implications of particular instances of noncompliance discovered by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control procedures and the level of management or employees involved.

Reporting of Noncompliance

To Management

32. **The auditor should, as soon as practicable, either communicate with the audit committee, the board of directors and senior management, or obtain evidence that they are appropriately informed, regarding noncompliance that comes to the auditor's attention.** However, the auditor need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.
33. **If in the auditor's judgment the noncompliance is believed to be intentional and material, the auditor should communicate the finding without delay.**
34. **If the auditor suspects that members of senior management, including members of the board of directors, are involved in noncompliance, the auditor should report the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or a supervisory board.** Where no higher authority exists, or if the auditor believes that the report may not be acted upon or is unsure as to the person to whom to report, the auditor would consider seeking legal advice.

To the Users of the Auditor's Report on the Financial Statements

35. **If the auditor concludes that the noncompliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor should express a qualified or an adverse opinion.**
36. **If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance that may be material to the financial statements, has, or is likely to have, occurred, the auditor should express a qualified opinion or a disclaimer of opinion**

on the financial statements on the basis of a limitation on the scope of the audit.

37. **If the auditor is unable to determine whether noncompliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should consider the effect on the auditor's report.**

To Regulatory and Enforcement Authorities

38. The auditor's duty of confidentiality would ordinarily preclude reporting noncompliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statute, law or by courts of law (for example, in some countries the auditor is required to report noncompliance by financial institutions to the supervisory authorities). The auditor may need to seek legal advice in such circumstances, giving due consideration to the auditor's responsibility to the public interest.

Withdrawal from the Engagement

39. The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the noncompliance is not material to the financial statements. Factors that would affect the auditor's conclusion include the implications of the involvement of the highest authority within the entity which may affect the reliability of management representations, and the effects on the auditor of continuing association with the entity. In reaching such a conclusion, the auditor would ordinarily seek legal advice.
40. **As stated in the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants, on receipt of an inquiry from the proposed auditor, the existing auditor should advise whether there are any professional reasons why the proposed auditor should not accept the appointment.** The extent to which an existing auditor can discuss the affairs of a client with a proposed auditor will depend on whether the client's permission to do so has been obtained and/or the legal or ethical requirements that apply in each country relating to such disclosure. If there are any such reasons or other matters which need to be disclosed, the existing auditor would, taking account of the legal and ethical constraints, including where appropriate permission of the client, give details of the information and discuss freely with the proposed auditor all matters relevant to the appointment. **If permission from the client to discuss its affairs with the proposed auditor is denied by the client, that fact should be disclosed to the proposed auditor.**

Public Sector Perspective

1. *Many public sector engagements include additional audit responsibilities with respect to consideration of laws and regulations. Even if the auditor's responsibilities do not extend beyond those of the private sector auditor, reporting responsibilities may be different as the public sector auditor may be*

CONSIDERATION OF LAWS AND REGULATIONS

obliged to report on instances of noncompliance to governing authorities or to report them in the audit report. In respect to public sector entities, the Public Sector Committee has supplemented the guidance included in this ISA in its Study 3 “Auditing for Compliance with Authorities—A Public Sector Perspective.”

Appendix

Indications That Noncompliance May Have Occurred

Examples of the type of information that may come to the auditor's attention that may indicate that noncompliance with laws or regulations has occurred are listed below:

- Investigation by government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' checks payable to bearer or transfers to numbered bank accounts.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an accounting system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorized transactions or improperly recorded transactions.
- Media comment.

INTERNATIONAL STANDARD ON AUDITING 260
COMMUNICATION OF AUDIT MATTERS WITH THOSE
CHARGED WITH GOVERNANCE

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA, not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the object of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on communication of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity. These communications relate to audit matters of governance interest as defined in this ISA. This ISA does not provide guidance on communications by the auditor to parties outside the entity, for example, external regulatory or supervisory agencies.
2. **The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity.**
3. For the purposes of this ISA, “governance” is the term used to describe the role of persons entrusted with the supervision, control and direction of an entity.¹ Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.
4. For the purpose of this ISA, “audit matters of governance interest” are those that arise from the audit of financial statements and, in the opinion of the auditor, are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required, in an audit in accordance with ISAs, to design procedures for the specific purpose of identifying matters of governance interest.

Relevant Persons

5. **The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated.**
6. The structures of governance vary from country to country reflecting cultural and legal backgrounds. For example, in some countries, the supervision function, and the management function are legally separated into different bodies, such as a supervisory (wholly or mainly non-executive) board and a management (executive) board. In other countries, both functions are the legal responsibility of a single, unitary board, although there may be an audit

¹ Principles of corporate governance have been developed by many countries as a point of reference for the establishment of good corporate behavior. Such principles generally focus on publicly traded companies; however, they may also serve to improve governance in other forms of entities. There is no single model of good corporate governance. Board structures and practices vary from country to country. A common principle is that the entity should have in place a governance structure which enables the board to exercise objective judgment on corporate affairs, including financial reporting, independent in particular from management.

committee that assists that board in its governance responsibilities with respect to financial reporting.

7. This diversity makes it difficult to establish a universal identification of the persons who are charged with governance and with whom the auditor communicates audit matters of governance interest. The auditor uses judgment to determine those persons with whom audit matters of governance interest are communicated, taking into account the governance structure of the entity, the circumstances of the engagement and any relevant legislation. The auditor also considers the legal responsibilities of those persons. For example, in entities with supervisory boards or with audit committees, the relevant persons may be those bodies. However, in entities where a unitary board has established an audit committee, the auditor may decide to communicate with the audit committee, or with the whole board, depending on the importance of the audit matters of governance interest.
8. When the entity's governance structure is not well defined, or those charged with governance are not clearly identified by the circumstances of the engagement, or by legislation, the auditor comes to an agreement with the entity about with whom audit matters of governance interest are to be communicated. Examples include some owner-managed entities, some not for profit organizations, and some government agencies.
9. To avoid misunderstandings, an audit engagement letter may explain that the auditor will communicate only those matters of governance interest that come to attention as a result of the performance of an audit and that the auditor is not required to design procedures for the specific purpose of identifying matters of governance interest. The engagement letter may also:
 - Describe the form in which any communications on audit matters of governance interest will be made;
 - Identify the relevant persons with whom such communications will be made;
 - Identify any specific audit matters of governance interest which it has been agreed are to be communicated.
10. The effectiveness of communications is enhanced by developing a constructive working relationship between the auditor and those charged with governance. This relationship is developed while maintaining an attitude of professional independence and objectivity.

Audit Matters of Governance Interest to be Communicated

11. **The auditor should consider audit matters of governance interest that arise from the audit of the financial statements and communicate them with those charged with governance.** Ordinarily such matters include:
 - The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;

- The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
 - The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
 - Audit adjustments, whether or not recorded by the entity that have, or could have, a significant effect on the entity's financial statements;
 - Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
 - Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;
 - Expected modifications to the auditor's report;
 - Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management;
 - Any other matters agreed upon in the terms of the audit engagement.
12. As part of the auditor's communications, those charged with governance are informed that:
- The auditor's communications of matters include only those audit matters of governance interest that have come to the attention of the auditor as a result of the performance of the audit; and
 - an audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. Accordingly, the audit does not ordinarily identify all such matters.

Timing of Communications

13. **The auditor should communicate audit matters of governance interest on a timely basis.** This enables those charged with governance to take appropriate action.
14. In order to achieve timely communications, the auditor discusses with those charged with governance the basis and timing of such communications. In certain cases, because of the nature of the matter, the auditor may communicate that matter sooner than previously agreed.

Forms of Communications

15. The auditor's communications with those charged with governance may be made orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by factors such as:
 - The size, operating structure, legal structure, and communications processes of the entity being audited;
 - The nature, sensitivity and significance of the audit matters of governance interest to be communicated;
 - The arrangements made with respect to periodic meetings or reporting of audit matters of governance interest;
 - The amount of on-going contact and dialogue the auditor has with those charged with governance.
16. When audit matters of governance interest are communicated orally, the auditor documents in the working papers the matters communicated and any responses to those matters. This documentation may take the form of a copy of the minutes of the auditor's discussion with those charged with governance. In certain circumstances, depending on the nature, sensitivity, and significance of the matter, it may be advisable for the auditor to confirm in writing with those charged with governance any oral communications on audit matters of governance interest.
17. Ordinarily, the auditor initially discusses audit matters of governance interest with management, except where those matters relate to questions of management competence or integrity. These initial discussions with management are important in order to clarify facts and issues, and to give management an opportunity to provide further information. If management agrees to communicate a matter of governance interest with those charged with governance, the auditor may not need to repeat the communications, provided that the auditor is satisfied that such communications have effectively and appropriately been made.

Other Matters

18. If the auditor considers that a modification of the auditor's report on the financial statements is required, as described in ISA 700, "The Auditor's Report on Financial Statements," communications between the auditor and those charged with governance cannot be regarded as a substitute.
19. The auditor considers whether audit matters of governance interest previously communicated may have an effect on the current year's financial statements. The auditor considers whether the point continues to be a matter of governance interest and whether to communicate the matter again with those charged with governance.

Confidentiality

20. The requirements of national professional accountancy bodies, legislation or regulation may impose obligations of confidentiality that restrict the auditor's communications of audit matters of governance interest. The auditor refers to such requirements, laws and regulations before communicating with those charged with governance. In some circumstances, the potential conflicts with the auditor's ethical and legal obligations of confidentiality and reporting may be complex. In these cases, the auditor may wish to consult with legal counsel.

Laws and Regulations

21. The requirements of national professional accountancy bodies, legislation or regulation may impose obligations on the auditor to make communications on governance related matters. These additional communications requirements are not covered by this ISA; however, they may affect the content, form and timing of communications with those charged with governance.

Effective Date

22. This ISA is effective for audits of financial statements for periods ending on or after December 31, 2000.

Public Sector Perspective

1. *While the basic principles contained in this ISA apply to the audit of financial statements in the public sector, the legislation giving rise to the audit mandate may specify the nature, content and form of the communications with those charged with governance of the entity.*
2. *For public sector audits, the types of matters that may be of interest to the governing body may be broader than the types of matters discussed in the ISA, which are directly related to the audit of financial statements. Public sector auditors' mandates may require them to report matters that come to their attention that relate to:*
 - *Compliance with legislative or regulatory requirements and related authorities;*
 - *Adequacy of accounting and control systems;*
 - *Economy, efficiency and effectiveness of programs, projects and activities.*
3. *For public sector auditors, the auditors' written communications may be placed on the public record. For that reason, the public sector auditor needs to be aware that their written communications may be distributed to a wider audience than solely those persons charged with governance of the entity.*

INTERNATIONAL STANDARD ON AUDITING 300

PLANNING

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

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In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on planning an audit of financial statements. This ISA is framed in the context of recurring audits. In a first audit, the auditor may need to extend the planning process beyond the matters discussed herein.
2. **The auditor should plan the audit work so that the audit will be performed in an effective manner.**
3. “Planning” means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit. The auditor plans to perform the audit in an efficient and timely manner.

Planning the Work

4. Adequate planning of the audit work helps to ensure that appropriate attention is devoted to important areas of the audit, that potential problems are identified and that the work is completed expeditiously. Planning also assists in proper assignment of work to assistants and in coordination of work done by other auditors and experts.
5. The extent of planning will vary according to the size of the entity, the complexity of the audit and the auditor’s experience with the entity and knowledge of the business.
6. Obtaining knowledge of the business is an important part of planning the work. The auditor’s knowledge of the business assists in the identification of events, transactions and practices which may have a material effect on the financial statements.
7. The auditor may wish to discuss elements of the overall audit plan and certain audit procedures with the entity’s audit committee, management and staff to improve the effectiveness and efficiency of the audit and to coordinate audit procedures with work of the entity’s personnel. The overall audit plan and the audit program, however, remain the auditor’s responsibility.

The Overall Audit Plan

8. **The auditor should develop and document an overall audit plan describing the expected scope and conduct of the audit.** While the record of the overall audit plan will need to be sufficiently detailed to guide the development of the audit program, its precise form and content will vary depending on the size of the entity, the complexity of the audit and the specific methodology and technology used by the auditor.
9. Matters to be considered by the auditor in developing the overall audit plan include:

Knowledge of the Business

- General economic factors and industry conditions affecting the entity's business.
- Important characteristics of the entity, its business, its financial performance and its reporting requirements including changes since the date of the prior audit.
- The general level of competence of management.

Understanding the Accounting and Internal Control Systems

- The accounting policies adopted by the entity and changes in those policies.
- The effect of new accounting or auditing pronouncements.
- The auditor's cumulative knowledge of the accounting and internal control systems and the relative emphasis expected to be placed on tests of control and substantive procedures.

Risk and Materiality

- The expected assessments of inherent and control risks and the identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- The possibility of material misstatement, including the experience of past periods, or fraud.
- The identification of complex accounting areas including those involving accounting estimates.

Nature, Timing and Extent of Procedures

- Possible change of emphasis on specific audit areas.
- The effect of information technology on the audit.
- The work of internal auditing and its expected effect on external audit procedures.

Coordination, Direction, Supervision and Review

- The involvement of other auditors in the audit of components, for example, subsidiaries, branches and divisions.
- The involvement of experts.
- The number of locations.
- Staffing requirements.

Other Matters

- The possibility that the going concern assumption may be subject to question.
- Conditions requiring special attention, such as the existence of related parties.
- The terms of the engagement and any statutory responsibilities.
- The nature and timing of reports or other communication with the entity that are expected under the engagement.

The Audit Program

10. **The auditor should develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the overall audit plan.** The audit program serves as a set of instructions to assistants involved in the audit and as a means to control and record the proper execution of the work. The audit program may also contain the audit objectives for each area and a time budget in which hours are budgeted for the various audit areas or procedures.
11. In preparing the audit program, the auditor would consider the specific assessments of inherent and control risks and the required level of assurance to be provided by substantive procedures. The auditor would also consider the timing of tests of controls and substantive procedures, the coordination of any assistance expected from the entity, the availability of assistants and the involvement of other auditors or experts. The other matters noted in paragraph 9 may also need to be considered in more detail during the development of the audit program.

Changes to the Overall Audit Plan and Audit Program

12. **The overall audit plan and the audit program should be revised as necessary during the course of the audit.** Planning is continuous throughout the engagement because of changes in conditions or unexpected results of audit procedures. The reasons for significant changes would be recorded.

INTERNATIONAL STANDARD ON AUDITING 310

KNOWLEDGE OF THE BUSINESS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

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ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on what is meant by a knowledge of the business, why it is important to the auditor and to members of the audit staff working on an engagement, why it is relevant to all phases of an audit, and how the auditor obtains and uses that knowledge.
2. **In performing an audit of financial statements, the auditor should have or obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.** For example, such knowledge is used by the auditor in assessing inherent and control risks and in determining the nature, timing and extent of audit procedures.
3. The auditor's level of knowledge for an engagement would include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates. The level of knowledge required by the auditor would, however, ordinarily be less than that possessed by management. A list of matters to consider in a specific engagement is set out in the Appendix to this ISA.

Obtaining the Knowledge

4. Prior to accepting an engagement, the auditor would obtain a preliminary knowledge of the industry and of the ownership, management and operations of the entity to be audited, and would consider whether a level of knowledge of the business adequate to perform the audit can be obtained.
5. Following acceptance of the engagement, further and more detailed information would be obtained. To the extent practicable, the auditor would obtain the required knowledge at the start of the engagement. As the audit progresses, that information would be assessed and updated and more information would be obtained.
6. Obtaining the required knowledge of the business is a continuous and cumulative process of gathering and assessing the information and relating the resulting knowledge to audit evidence and information at all stages of the audit. For example, although information is gathered at the planning stage, it is ordinarily refined and added to in later stages of the audit as the auditor and assistants learn more about the business.
7. For continuing engagements, the auditor would update and reevaluate information gathered previously, including information in the prior year's working papers. The auditor would also perform procedures designed to identify significant changes that have taken place since the last audit.
8. The auditor can obtain a knowledge of the industry and the entity from a number of sources. For example:

- Previous experience with the entity and its industry.
- Discussion with people with the entity (for example, directors and senior operating personnel).
- Discussion with internal audit personnel and review of internal audit reports.
- Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry.
- Discussion with knowledgeable people outside the entity (for example, industry economists, industry regulators, customers, suppliers, competitors).
- Publications related to the industry (for example, government statistics, surveys, texts, trade journals, reports prepared by banks and securities dealers, financial newspapers).
- Legislation and regulations that significantly affect the entity.
- Visits to the entity's premises and plant facilities.
- Documents produced by the entity (for example, minutes of meetings, material sent to shareholders or filed with regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manual, manuals of accounting and internal control systems, chart of accounts, job descriptions, marketing and sales plans).

Using the Knowledge

9. A knowledge of the business is a frame of reference within which the auditor exercises professional judgment. Understanding the business and using this information appropriately assists the auditor in:
 - Assessing risks and identifying problems.
 - Planning and performing the audit effectively and efficiently.
 - Evaluating audit evidence.
 - Providing better service to the client.
10. The auditor makes judgments about many matters throughout the course of the audit where knowledge of the business is important. For example:
 - Assessing inherent risk and control risk.
 - Considering business risks and management's response thereto.
 - Developing the overall audit plan and the audit program.
 - Determining a materiality level and assessing whether the materiality level chosen remains appropriate.

- Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions.
 - Evaluating accounting estimates and management representations.
 - Identifying areas where special audit consideration and skills may be necessary.
 - Identifying related parties and related party transactions.
 - Recognizing conflicting information (for example, contradictory representations).
 - Recognizing unusual circumstances (for example, fraud and noncompliance with laws and regulations, unexpected relationships of statistical operating data with reported financial results).
 - Making informed inquiries and assessing the reasonableness of answers.
 - Considering the appropriateness of accounting policies and financial statement disclosures.
11. **The auditor should ensure that assistants assigned to an audit engagement obtain sufficient knowledge of the business to enable them to carry out the audit work delegated to them.** The auditor would also ensure they understand the need to be alert for additional information and the need to share that information with the auditor and other assistants.
12. **To make effective use of knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.**

Appendix

Knowledge of the Business—Matters to Consider

This list covers a broad range of matters applicable to many engagements; however, not all matters will be relevant to every engagement and the listing is not necessarily complete.

A. General Economic Factors

- General level of economic activity (for example, recession, growth)
- Interest rates and availability of financing
- Inflation, currency revaluation
- Government policies
 - monetary
 - fiscal
 - taxation—corporate and other
 - financial incentives (for example, government aid programs)
 - tariffs, trade restrictions
- Foreign currency rates and controls

B. The Industry—Important Conditions Affecting the Client's Business

- The market and competition
- Cyclical or seasonal activity
- Changes in product technology
- Business risk (for example, high technology, high fashion, ease of entry for competition)
- Declining or expanding operations
- Adverse conditions (for example, declining demand, excess capacity, serious price competition)
- Key ratios and operating statistics
- Specific accounting practices and problems
- Environmental requirements and problems
- Regulatory framework
- Energy supply and cost

- Specific or unique practices (for example, relating to labor contracts, financing methods, accounting methods)

C. *The Entity*

1. Management and ownership—important characteristics
 - Corporate structure—private, public, government (including any recent or planned changes)
 - Beneficial owners and related parties (local, foreign, business reputation and experience)
 - Capital structure (including any recent or planned changes)
 - Organizational structure
 - Management objectives, philosophy, strategic plans
 - Acquisitions, mergers or disposals of business activities (planned or recently executed)
 - Sources and methods of financing (current, historical)
 - Board of directors
 - Composition
 - Business reputation and experience of individuals
 - Independence from and control over operating management
 - Frequency of meetings
 - Existence of audit committee and scope of its activities
 - Existence of policy on corporate conduct
 - Changes in professional advisors (for example, lawyers)
 - Operating Management
 - Experience and reputation
 - Turnover
 - Key financial personnel and their status in the organization
 - Staffing of accounting department
 - Incentive or bonus plans as part of remuneration (for example, based on profit)
 - Use of forecasts and budgets
 - Pressures on management (for example, overextended, dominance by one individual, support for share price, unreasonable deadlines for announcing results)

- Management information systems
 - Internal audit function (existence, quality)
 - Attitude to internal control environment
2. The entity's business—products, markets, suppliers, expenses, operations
 - Nature of business(es) (for example, manufacturer, wholesaler, financial services, import/export)
 - Location of production facilities, warehouses, offices
 - Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation)
 - Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes)
 - Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as “just-in-time”)
 - Inventories (for example, locations, quantities)
 - Franchises, licenses, patents
 - Important expense categories
 - Research and development
 - Foreign currency assets, liabilities and transactions—by currency, hedging
 - Legislation and regulation that significantly affect the entity
 - Information systems—current, plans to change
 - Debt structure, including covenants and restrictions
 3. Financial performance—factors concerning the entity's financial condition and profitability
 - Key ratios and operating statistics
 - Trends
 4. Reporting environment—external influences which affect management in the preparation of the financial statements
 5. Legislation
 - Regulatory environment and requirements

KNOWLEDGE OF THE BUSINESS

- Taxation
- Measurement and disclosure issues peculiar to the business
- Audit reporting requirements
- Users of the financial statements

INTERNATIONAL STANDARD ON AUDITING 320

AUDIT MATERIALITY

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Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the concept of materiality and its relationship with audit risk.
2. **The auditor should consider materiality and its relationship with audit risk when conducting an audit.**
3. “Materiality” is defined in the International Accounting Standards Committee’s “Framework for the Preparation and Presentation of Financial Statements” in the following terms:

“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.”

Materiality

4. **The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.** The assessment of what is material is a matter of professional judgment.
5. In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However, both the amount (quantity) and nature (quality) of misstatements need to be considered. Examples of qualitative misstatements would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.
6. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated each month.
7. The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by considerations such as legal and regulatory requirements and considerations relating to individual financial statement account balances and relationships. This process may result in

different materiality levels depending on the aspect of the financial statements being considered.

8. **Materiality should be considered by the auditor when:**
 - (a) **Determining the nature, timing and extent of audit procedures; and**
 - (b) **Evaluating the effect of misstatements.**

The Relationship between Materiality and Audit Risk

9. When planning the audit, the auditor considers what would make the financial statements materially misstated. The auditor's assessment of materiality, related to specific account balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level.
10. There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:
 - (a) Reducing the assessed level of control risk, where this is possible, and supporting the reduced level by carrying out extended or additional tests of control; or
 - (b) Reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

Materiality and Audit Risk in Evaluating Audit Evidence

11. The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from at the time of evaluating the results of audit procedures. This could be because of a change in circumstances or because of a change in the auditor's knowledge as a result of the audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally, the auditor may, in planning the audit work, intentionally set the acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. This may be done to reduce the likelihood of undiscovered misstatements and to provide the auditor with a margin of safety when evaluating the effect of misstatements discovered during the audit.

Evaluating the Effect of Misstatements

12. **In evaluating the fair presentation of the financial statements the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material.**
13. The aggregate of uncorrected misstatements comprises:
 - (a) Specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and
 - (b) The auditor's best estimate of other misstatements which cannot be specifically identified (*i.e.*, projected errors).
14. The auditor needs to consider whether the aggregate of uncorrected misstatements is material. If the auditor concludes that the misstatements may be material, the auditor needs to consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements. In any event, management may want to adjust the financial statements for the misstatements identified.
15. **If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider the appropriate modification to the auditor's report in accordance with ISA 700 "The Auditor's Report on Financial Statements."**
16. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, the auditor would consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditor would consider reducing the risk by performing additional audit procedures or by requesting management to adjust the financial statements for identified misstatements.

Public Sector Perspective

1. *In assessing materiality, the public sector auditor must, in addition to exercising professional judgment, consider any legislation or regulation which may impact that assessment. In the public sector, materiality is also based on the "context and nature" of an item and includes, for example, sensitivity as well as value. Sensitivity covers a variety of matters such as compliance with authorities, legislative concern or public interest.*

INTERNATIONAL STANDARD ON AUDITING 400
RISK ASSESSMENTS AND INTERNAL CONTROL
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Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on obtaining an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk.
2. **The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgment to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.**
3. “Audit risk” means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.
4. “Inherent risk” is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
5. “Control risk” is the risk that a misstatement, that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.
6. “Detection risk” is the risk that an auditor’s substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.
7. “Accounting system” means the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.
8. “Internal control system” means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal control system extends beyond those matters which relate directly to the functions of the accounting system and comprises:
 - (a) “The control environment” which means the overall attitude, awareness and actions of directors and management regarding the internal control

system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:

- The function of the board of directors and its committees.
 - Management's philosophy and operating style.
 - The entity's organizational structure and methods of assigning authority and responsibility.
 - Management's control system including the internal audit function, personnel policies and procedures and segregation of duties.
- (b) "Control procedures" which means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Specific control procedures include:
- Reporting, reviewing and approving reconciliations.
 - Checking the arithmetical accuracy of the records.
 - Controlling applications and environment of computer information systems, for example, by establishing controls over:
 - changes to computer programs
 - access to data files.
 - Maintaining and reviewing control accounts and trial balances.
 - Approving and controlling of documents.
 - Comparing internal data with external sources of information.
 - Comparing the results of cash, security and inventory counts with accounting records.
 - Limiting direct physical access to assets and records.
 - Comparing and analyzing the financial results with budgeted amounts.
9. In the audit of financial statements, the auditor is only concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statement assertions. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessments and other considerations, will enable the auditor to:

- (a) Identify the types of potential material misstatements that could occur in the financial statements;
 - (b) Consider factors that affect the risk of material misstatements; and
 - (c) Design appropriate audit procedures.
10. When developing the audit approach, the auditor considers the preliminary assessment of control risk (in conjunction with the assessment of inherent risk) to determine the appropriate detection risk to accept for the financial statement assertions and to determine the nature, timing and extent of substantive procedures for such assertions.

Inherent Risk

11. **In developing the overall audit plan, the auditor should assess inherent risk at the financial statement level. In developing the audit program, the auditor should relate such assessment to material account balances and classes of transactions at the assertion level, or assume that inherent risk is high for the assertion.**
12. To assess inherent risk, the auditor uses professional judgment to evaluate numerous factors, examples of which are:

At the Financial Statement Level

- The integrity of management.
- Management experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.
- Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.
- The nature of the entity's business, for example, the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.
- Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as identified by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the Account Balance and Class of Transactions Level

- Financial statement accounts likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.

- The complexity of underlying transactions and other events which might require using the work of an expert.
- The degree of judgment involved in determining account balances.
- Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
- The completion of unusual and complex transactions, particularly at or near period end.
- Transactions not subjected to ordinary processing.

Accounting and Internal Control Systems

13. Internal controls relating to the accounting system are concerned with achieving objectives such as:
 - Transactions are executed in accordance with management's general or specific authorization.
 - All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with an identified financial reporting framework.
 - Access to assets and records is permitted only in accordance with management's authorization.
 - Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken regarding any differences.

Inherent Limitations of Internal Controls

14. Accounting and internal control systems cannot provide management with conclusive evidence that objectives are reached because of inherent limitations. Such limitations include:
 - Management's usual requirement that the cost of an internal control does not exceed the expected benefits to be derived.
 - Most internal controls tend to be directed at routine transactions rather than non-routine transactions.
 - The potential for human error due to carelessness, distraction, mistakes of judgment and the misunderstanding of instructions.
 - The possibility of circumvention of internal controls through the collusion of a member of management or an employee with parties outside or inside the entity.
 - The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.

- The possibility that procedures may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.

Understanding the Accounting and Internal Control Systems

15. When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains a knowledge of the design of the accounting and internal control systems, and their operation. For example, an auditor may perform a “walk-through” test, that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk-through tests performed by the auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.
16. The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things:
 - The size and complexity of the entity and of its computer system.
 - Materiality considerations.
 - The type of internal controls involved.
 - The nature of the entity’s documentation of specific internal controls.
 - The auditor’s assessment of inherent risk.
17. Ordinarily, the auditor’s understanding of the accounting and internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:
 - (a) Inquiries of appropriate management, supervisory and other personnel at various organizational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions and flow charts;
 - (b) Inspection of documents and records produced by the accounting and internal control systems; and
 - (c) Observation of the entity’s activities and operations, including observation of the organization of computer operations, management personnel and the nature of transaction processing.

Accounting System

18. **The auditor should obtain an understanding of the accounting system sufficient to identify and understand:**
 - (a) **Major classes of transactions in the entity’s operations;**

- (b) **How such transactions are initiated;**
- (c) **Significant accounting records, supporting documents and accounts in the financial statements; and**
- (d) **The accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.**

Control Environment

- 19. **The auditor should obtain an understanding of the control environment sufficient to assess directors' and management's attitudes, awareness and actions regarding internal controls and their importance in the entity.**

Control Procedures

- 20. **The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan.** In obtaining this understanding, the auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether any additional understanding of control procedures is necessary. Because control procedures are integrated with the control environment and the accounting system, as the auditor obtains an understanding of the control environment and the accounting system, some knowledge about control procedures is also likely to be obtained, for example, in obtaining an understanding of the accounting system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled. Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

Control Risk

Preliminary Assessment of Control Risk

- 21. The preliminary assessment of control risk is the process of evaluating the effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements. There will always be some control risk because of the inherent limitations of any accounting and internal control system.
- 22. **After obtaining an understanding of the accounting and internal control systems, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.**
- 23. The auditor ordinarily assesses control risk at a high level for some or all assertions when:

- (a) The entity's accounting and internal control systems are not effective; or
 - (b) Evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.
24. **The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:**
- (a) **Is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and**
 - (b) **Plans to perform tests of control to support the assessment.**

Documentation of Understanding and Assessment of Control Risk

25. **The auditor should document in the audit working papers:**
- (a) **The understanding obtained of the entity's accounting and internal control systems; and**
 - (b) **The assessment of control risk.** When control risk is assessed at less than high, the auditor would also document the basis for the conclusions.
26. Different techniques may be used to document information relating to accounting and internal control systems. Selection of a particular technique is a matter for the auditor's judgment. Common techniques, used alone or in combination, are narrative descriptions, questionnaires, check lists and flow charts. The form and extent of this documentation is influenced by the size and complexity of the entity and the nature of the entity's accounting and internal control systems. Generally, the more complex the entity's accounting and internal control systems and the more extensive the auditor's procedures, the more extensive the auditor's documentation will need to be.

Tests of Control

27. Tests of control are performed to obtain audit evidence about the effectiveness of the:
- (a) Design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and
 - (b) Operation of the internal controls throughout the period.
28. Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the

effectiveness of the bank reconciliation process through inquiry and observation.

29. When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient, to support a control risk assessment at less than a high level.
30. Tests of control may include:
 - Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorized.
 - Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function not merely who is supposed to perform it.
 - Reperformance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
31. **The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more support the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively.**
32. When obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognizes that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.
33. In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The auditor may find it necessary, or may prefer, to use computer-assisted audit techniques. The use of such techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerized accounting system.
34. **Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated**

in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Quality and Timeliness of Audit Evidence

35. Certain types of audit evidence obtained by the auditor are more reliable than others. Ordinarily, the auditor's observation provides more reliable audit evidence than merely making inquiries, for example, the auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.
36. In determining the appropriate audit evidence to support a conclusion about control risk, the auditor may consider the audit evidence obtained in prior audits. In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control. **Before relying on procedures performed in prior audits, the auditor should obtain audit evidence which supports this reliance.** The auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance. The longer the time elapsed since the performance of such procedures the less assurance that may result.
37. **The auditor should consider whether the internal controls were in use throughout the period.** If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period.
38. The auditor may decide to perform some tests of control during an interim visit in advance of the period end. However, the auditor cannot rely on the results of such tests without considering the need to obtain further audit evidence relating to the remainder of the period. Factors to be considered include:
 - The results of the interim tests.
 - The length of the remaining period.
 - Whether any changes have occurred in the accounting and internal control systems during the remaining period.

- The nature and amount of the transactions and other events and the balances involved.
- The control environment, especially supervisory controls.
- The substantive procedures which the auditor plans to carry out.

Final Assessment of Control Risk

39. **Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed.**

Relationship Between the Assessments of Inherent and Control Risks

40. Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

Detection Risk

41. The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level. Some detection risk would always be present even if an auditor were to examine 100 percent of the account balance or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.
42. **The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level.** In this regard the auditor would consider:
- (a) The nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;
 - (b) The timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and
 - (c) The extent of substantive procedures, for example, using a larger sample size.

43. There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level. Refer to the Appendix to this ISA for an illustration of the interrelationship of the components of audit risk.
44. While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other. Misstatements discovered in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk. Refer to the Appendix to this ISA for an illustration of the interrelationship of the components of audit risk.
45. The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. **Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.**
46. The auditor's assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.
47. **The higher the assessment of inherent and control risk, the more audit evidence the auditor should obtain from the performance of substantive procedures.** When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. **When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion.**

Audit Risk in the Small Business

48. The auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities. However, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in

some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures.

Communication of Weaknesses

49. As a result of obtaining an understanding of the accounting and internal control systems and tests of control, the auditor may become aware of weaknesses in the systems. **The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention.** The communication to management of material weaknesses would ordinarily be in writing. However, if the auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

Public Sector Perspective

1. *In respect of paragraph 8 of this ISA, the auditor has to be aware that the "management objectives" of public sector entities may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, government ordinances, and ministerial directives. The source and nature of these objectives have to be considered by the auditor in assessing whether the internal control procedures are effective for purposes of the audit.*
2. *Paragraph 9 of this ISA states that, in the audit of financial statements, the auditor is only concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statement assertions. Public sector auditors often have additional responsibilities, even in the context of their financial statement audits, with respect to internal controls. Their review of the internal controls may be broader and more detailed than in an audit of financial statements in the private sector.*
3. *Paragraph 49 of this ISA deals with communication of weaknesses. There may be additional reporting requirements for public sector auditors. For example, internal control weaknesses found in the financial statement and other audits may have to be reported to the legislature or other governing body.*

Appendix

Illustration of the Interrelationship of the Components of Audit Risk

The following table shows how the acceptable level of detection risk may vary based on assessments of inherent and control risks.

		Auditor's assessment of control risk is:		
		High	Medium	Low
Auditor's assessment of inherent risk	High	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

The shaded areas in this table relate to detection risk.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

INTERNATIONAL STANDARD ON AUDITING 401

AUDITING IN A COMPUTER INFORMATION SYSTEMS ENVIRONMENT

CONTENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on procedures to be followed when an audit is conducted in a computer information systems (CIS)¹ environment. For purposes of ISAs, a CIS environment exists when a computer of any type or size is involved in the processing by the entity of financial information of significance to the audit, whether that computer is operated by the entity or by a third party.
2. **The auditor should consider how a CIS environment affects the audit.**
3. The overall objective and scope of an audit does not change in a CIS environment. However, the use of a computer changes the processing, storage and communication of financial information and may affect the accounting and internal control systems employed by the entity. Accordingly, a CIS environment may affect:
 - The procedures followed by the auditor in obtaining a sufficient understanding of the accounting and internal control systems.
 - The consideration of inherent risk and control risk through which the auditor arrives at the risk assessment.
 - The auditor's design and performance of tests of control and substantive procedures appropriate to meet the audit objective.

Skills and Competence

4. **The auditor should have sufficient knowledge of the CIS to plan, direct, supervise and review the work performed. The auditor should consider whether specialized CIS skills are needed in an audit.** These may be needed to:
 - Obtain a sufficient understanding of the accounting and internal control systems affected by the CIS environment.
 - Determine the effect of the CIS environment on the assessment of overall risk and of risk at the account balance and class of transactions level.
 - Design and perform appropriate tests of control and substantive procedures.

If specialized skills are needed, the auditor would seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. **If the use of such a professional is planned, the auditor should obtain sufficient appropriate audit evidence that such**

¹ This term is used throughout this ISA in place of electronic data processing (EDP) used in prior ISA "Auditing in an EDP Environment." Related International Auditing Practice Statements revised and issued subsequent to this ISA use the term "information technology (IT) environments."

work is adequate for the purposes of the audit, in accordance with ISA 620 “Using the Work of an Expert.”

Planning

5. **In accordance with ISA 400 “Risk Assessments and Internal Control,” the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach.**
6. **In planning the portions of the audit which may be affected by the client’s CIS environment, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of data for use in the audit.** This understanding would include such matters as:
 - The significance and complexity of computer processing in each significant accounting application. Significance relates to materiality of the financial statement assertions affected by the computer processing. An application may be considered to be complex when, for example:
 - The volume of transactions is such that users would find it difficult to identify and correct errors in processing.
 - The computer automatically generates material transactions or entries directly to another application.
 - The computer performs complicated computations of financial information and/or automatically generates material transactions or entries that cannot be (or are not) validated independently.
 - Transactions are exchanged electronically with other organizations (as in electronic data interchange (EDI) systems) without manual review for propriety or reasonableness.
 - The organizational structure of the client’s CIS activities and the extent of concentration or distribution of computer processing throughout the entity, particularly as they may affect segregation of duties.
 - The availability of data. Source documents, certain computer files, and other evidential matter that may be required by the auditor may exist for only a short period or only in machine-readable form. Client CIS may generate internal reporting that may be useful in performing substantive tests (particularly analytical procedures). The potential for use of computer-assisted audit techniques may permit increased efficiency in the performance of audit procedures, or may enable the auditor to economically apply certain procedures to an entire population of accounts or transactions.
7. **When the CIS are significant, the auditor should also obtain an understanding of the CIS environment and whether it may influence the**

assessment of inherent and control risks. The nature of the risks and the internal control characteristics in CIS environments include the following:

- Lack of transaction trails. Some CIS are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.
- Uniform processing of transactions. Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systematic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.
- Lack of segregation of functions. Many control procedures that would ordinarily be performed by separate individuals in manual systems may be concentrated in CIS. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.
- Potential for errors and irregularities. The potential for human error in the development, maintenance and execution of CIS may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorized access to data or to alter data without visible evidence may be greater in CIS than in manual systems.
- In addition, decreased human involvement in handling transactions processed by CIS can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.
- Initiation or execution of transactions. CIS may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorization of these transactions or procedures may not be documented in the same way as those in a manual system, and management's authorization of these transactions may be implicit in its acceptance of the design of the CIS and subsequent modification.
- Dependence of other controls over computer processing. Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing. In turn, the effectiveness and consistent operation of transaction processing controls

in computer applications is often dependent on the effectiveness of general CIS controls.

- Potential for increased management supervision. CIS can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these additional controls, if used, may serve to enhance the entire internal control structure.
- Potential for the use of computer-assisted audit techniques. The ease of processing and analyzing large quantities of data using computers may provide the auditor with opportunities to apply general or specialized computer audit techniques and tools in the execution of audit tests.

Both the risks and the controls introduced as a result of these characteristics of CIS have a potential impact on the auditor's assessment of risk, and the nature, timing and extent of audit procedures.

Assessment of Risk

8. **In accordance with ISA 400 "Risk Assessments and Internal Control," the auditor should make an assessment of inherent and control risks for material financial statement assertions.**
9. The inherent risks and control risks in a CIS environment may have both a pervasive effect and an account-specific effect on the likelihood of material misstatements, as follows:
 - The risks may result from deficiencies in pervasive CIS activities such as program development and maintenance, systems software support, operations, physical CIS security, and control over access to special-privilege utility programs. These deficiencies would tend to have a pervasive impact on all application systems that are processed on the computer.
 - The risks may increase the potential for errors or fraudulent activities in specific applications, in specific data bases or master files, or in specific processing activities. For example, errors are not uncommon in systems that perform complex logic or calculations, or that must deal with many different exception conditions. Systems that control cash disbursements or other liquid assets are susceptible to fraudulent actions by users or by CIS personnel.
10. As new CIS technologies emerge, they are frequently employed by clients to build increasingly complex computer systems that may include micro-to-mainframe links, distributed data bases, end-user processing, and business management systems that feed information directly into the accounting systems. Such systems increase the overall sophistication of CIS and the complexity of the specific applications that they affect. As a result, they may increase risk and require further consideration.

Audit Procedures

11. **In accordance with ISA 400 “Risk Assessments and Internal Control,” the auditor should consider the CIS environment in designing audit procedures to reduce audit risk to an acceptably low level.**
12. The auditor’s specific audit objectives do not change whether accounting data is processed manually or by computer. However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. The auditor can use either manual audit procedures, computer-assisted audit techniques, or a combination of both to obtain sufficient evidential matter. However, in some accounting systems that use a computer for processing significant applications, it may be difficult or impossible for the auditor to obtain certain data for inspection, inquiry, or confirmation without computer assistance.

INTERNATIONAL STANDARD ON AUDITING 402

AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANIZATIONS

CONTENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance to an auditor whose client uses a service organization. This ISA also describes the service organization auditor's reports which may be obtained by client auditors.
2. **The auditor should consider how a service organization affects the client's accounting and internal control systems so as to plan the audit and develop an effective audit approach.**
3. A client may use a service organization such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organization). If a client uses a service organization, certain policies, procedures and records maintained by the service organization may be relevant to the audit of the financial statements of the client.

Considerations of the Client Auditor

4. A service organization may establish and execute policies and procedures that affect a client organization's accounting and internal control systems. These policies and procedures are physically and operationally separate from the client organization. When the services provided by the service organization are limited to recording and processing client transactions and the client retains authorization and maintenance of accountability, the client may be able to implement effective policies and procedures within its organization. When the service organization executes the client's transactions and maintains accountability, the client may deem it necessary to rely on policies and procedures at the service organization.
5. **The auditor should determine the significance of service organization activities to the client and the relevance to the audit.** In doing so, the client auditor would need to consider the following, as appropriate:
 - Nature of the services provided by the service organization.
 - Terms of contract and relationship between the client and the service organization.
 - The material financial statement assertions that are affected by the use of the service organization.
 - Inherent risk associated with those assertions.
 - Extent to which the client's accounting and internal control systems interact with the systems at the service organization.
 - Client's internal controls that are applied to the transactions processed by the service organization.

- Service organization's capability and financial strength, including the possible effect of the failure of the service organization on the client.
- Information about the service organization such as that reflected in user and technical manuals.
- Information available on general controls and computer systems controls relevant to the client's applications.

Consideration of the above may lead the auditor to decide that the control risk assessment will not be affected by controls at the service organization; if so, further consideration of this ISA is unnecessary.

6. The client auditor would also consider the existence of third-party reports from service organization auditors, internal auditors, or regulatory agencies as a means of providing information about the accounting and internal control systems of the service organization and about its operation and effectiveness.
7. **If the client auditor concludes that the activities of the service organization are significant to the entity and relevant to the audit, the auditor should obtain sufficient information to understand the accounting and internal control systems and to assess control risk at either the maximum, or a lower level if tests of control are performed.**
8. If information is insufficient, the client auditor would consider the need to request the service organization to have its auditor perform such procedures as to supply the necessary information, or the need to visit the service organization to obtain the information. A client auditor wishing to visit a service organization may advise the client to request the service organization to give the client auditor access to the necessary information.
9. The client auditor may be able to obtain an understanding of the accounting and internal control systems affected by the service organization by reading the third-party report of the service organization auditor. In addition, when assessing control risk for assertions affected by the systems' controls of the service organization, the client auditor may also use the service organization auditor's report. **If the client auditor uses the report of a service organization auditor, the auditor should consider making inquiries concerning that auditor's professional competence in the context of the specific assignment undertaken by the service organization auditor.**
10. The client auditor may conclude that it would be efficient to obtain audit evidence from tests of control to support an assessment of control risk at a lower level. Such evidence may be obtained by:
 - Performing tests of the client's controls over activities of the service organization.
 - Obtaining a service organization auditor's report that expresses an opinion as to the operating effectiveness of the service organization's accounting

and internal control systems for the processing applications relevant to the audit.

- Visiting the service organization and performing tests of control.

Service Organization Auditor's Reports

11. **When using a service organization auditor's report, the client auditor should consider the nature of and content of that report.**
12. The report of the service organization auditor will ordinarily be one of two types as follows:

Type A—Report on suitability of design

- (a) A description of the service organization's accounting and internal control systems, ordinarily prepared by the management of the service organization; and
- (b) An opinion by the service organization auditor that:
 - (i) The above description is accurate;
 - (ii) The systems' controls have been placed in operation; and
 - (iii) The accounting and internal control systems are suitably designed to achieve their stated objectives.

Type B—Report on suitability of design and operating effectiveness

- (a) A description of the service organization's accounting and internal control systems, ordinarily prepared by the management of the service organization; and
- (b) An opinion by the service organization auditor that:
 - (i) The above description is accurate;
 - (ii) The systems' controls have been placed in operation;
 - (iii) The accounting and internal control systems are suitably designed to achieve their stated objectives; and
 - (iv) The accounting and internal control systems are operating effectively based on the results from the tests of control. In addition to the opinion on operating effectiveness, the service organization auditor would identify the tests of control performed and related results.

The report of the service organization auditor will ordinarily contain restrictions as to use (generally to management, the service organization and its customers, and client auditors).

13. **The client auditor should consider the scope of work performed by the service organization auditor and should assess the usefulness and appropriateness of reports issued by the service organization auditor.**

14. While Type A reports may be useful to a client auditor in gaining the required understanding of the accounting and internal control systems, an auditor would not use such reports as a basis for reducing the assessment of control risk.
15. In contrast, Type B reports may provide such a basis since tests of control have been performed. When a Type B report is to be used as evidence to support a lower control risk assessment, a client auditor would consider whether the controls tested by the service organization auditor are relevant to the client's transactions (significant assertions in the client's financial statements) and whether the service organization auditor's tests of control and the results are adequate. With respect to the latter, two key considerations are the length of the period covered by the service organization auditor's tests and the time since the performance of those tests.
16. **For those specific tests of control and results that are relevant, a client auditor should consider whether the nature, timing and extent of such tests provide sufficient appropriate audit evidence about the effectiveness of the accounting and internal control systems to support the client auditor's assessed level of control risk.**
17. The auditor of a service organization may be engaged to perform substantive procedures that are of use to a client auditor. Such engagements may involve the performance of procedures agreed upon by the client and its auditor and by the service organization and its auditor.
18. **When a client auditor uses a report from the auditor of a service organization, no reference should be made in the client auditor's report to the auditor's report on the service organization.**

INTERNATIONAL STANDARD ON AUDITING 500

AUDIT EVIDENCE

CONTENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the quantity and quality of audit evidence to be obtained when auditing financial statements, and the procedures for obtaining that audit evidence.
2. **The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.**
3. Audit evidence is obtained from an appropriate mix of tests of control and substantive procedures. In some circumstances, evidence may be obtained entirely from substantive procedures.
4. “Audit evidence” means the information obtained by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence will comprise source documents and accounting records underlying the financial statements and corroborating information from other sources.
5. “Tests of control” means tests performed to obtain audit evidence about the suitability of design and effective operation of the accounting and internal control systems.
6. “Substantive procedures” means tests performed to obtain audit evidence to detect material misstatements in the financial statements, and are of two types:
 - (a) Tests of details of transactions and balances; and
 - (b) Analytical procedures.

Sufficient Appropriate Audit Evidence

7. Sufficiency and appropriateness are interrelated and apply to audit evidence obtained from both tests of control and substantive procedures. Sufficiency is the measure of the quantity of audit evidence; appropriateness is the measure of the quality of audit evidence and its relevance to a particular assertion and its reliability. Ordinarily, the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive and will often seek audit evidence from different sources or of a different nature to support the same assertion.
8. In forming the audit opinion, the auditor does not ordinarily examine all of the information available because conclusions can be reached about an account balance, class of transactions or control by way of using judgmental or statistical sampling procedures.
9. The auditor’s judgment as to what is sufficient appropriate audit evidence is influenced by such factors as the:
 - Auditor’s assessment of the nature and level of inherent risk at both the financial statement level and the account balance or class of transactions level.

- Nature of the accounting and internal control systems and the assessment of control risk.
 - Materiality of the item being examined.
 - Experience gained during previous audits.
 - Results of audit procedures, including fraud or error which may have been found.
 - Source and reliability of information available.
10. **When obtaining audit evidence from tests of control, the auditor should consider the sufficiency and appropriateness of the audit evidence to support the assessed level of control risk.**
11. The aspects of the accounting and internal control systems about which the auditor would obtain audit evidence are:
- (a) *Design*: the accounting and internal control systems are suitably designed to prevent and/or detect and correct material misstatements; and
 - (b) *Operation*: the systems exist and have operated effectively throughout the relevant period.
12. **When obtaining audit evidence from substantive procedures, the auditor should consider the sufficiency and appropriateness of audit evidence from such procedures together with any evidence from tests of control to support financial statement assertions.**
13. Financial statement assertions are assertions by management, explicit or otherwise, that are embodied in the financial statements. They can be categorized as follows:
- (a) *Existence*: an asset or a liability exists at a given date;
 - (b) *Rights and obligations*: an asset or a liability pertains to the entity at a given date;
 - (c) *Occurrence*: a transaction or event took place which pertains to the entity during the period;
 - (d) *Completeness*: there are no unrecorded assets, liabilities, transactions or events, or undisclosed items;
 - (e) *Valuation*: an asset or liability is recorded at an appropriate carrying value;
 - (f) *Measurement*: a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period; and
 - (g) *Presentation and disclosure*: an item is disclosed, classified, and described in accordance with the applicable financial reporting framework.

14. Ordinarily, audit evidence is obtained regarding each financial statement assertion. Audit evidence regarding one assertion, for example, existence of inventory, will not compensate for failure to obtain audit evidence regarding another, for example, valuation. The nature, timing and extent of substantive procedures will vary depending on the assertions. Tests can provide audit evidence about more than one assertion, for example, collection of receivables may provide audit evidence regarding both existence and valuation.
15. The reliability of audit evidence is influenced by its source: internal or external, and by its nature: visual, documentary or oral. While the reliability of audit evidence is dependent on individual circumstance, the following generalizations will help in assessing the reliability of audit evidence:
 - Audit evidence from external sources (for example, confirmation received from a third party) is more reliable than that generated internally.
 - Audit evidence generated internally is more reliable when the related accounting and internal control systems are effective.
 - Audit evidence obtained directly by the auditor is more reliable than that obtained from the entity.
 - Audit evidence in the form of documents and written representations is more reliable than oral representations.
16. Audit evidence is more persuasive when items of evidence from different sources or of a different nature are consistent. In these circumstances, the auditor may obtain a cumulative degree of confidence higher than would be obtained from items of audit evidence when considered individually. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor determines what additional procedures are necessary to resolve the inconsistency.
17. The auditor needs to consider the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. However, the matter of difficulty and expense involved is not in itself a valid basis for omitting a necessary procedure.
18. When in substantial doubt as to a material financial statement assertion, the auditor would attempt to obtain sufficient appropriate audit evidence to remove such doubt. **If unable to obtain sufficient appropriate audit evidence, however, the auditor should express a qualified opinion or a disclaimer of opinion.**

Procedures for Obtaining Audit Evidence

19. The auditor obtains audit evidence by one or more of the following procedures: inspection, observation, inquiry and confirmation, computation and analytical procedures. The timing of such procedures will be dependent, in part, upon the periods of time during which the audit evidence sought is available.

Inspection

20. Inspection consists of examining records, documents, or tangible assets. Inspection of records and documents provides audit evidence of varying degrees of reliability depending on their nature and source and the effectiveness of internal controls over their processing. Three major categories of documentary audit evidence, which provide different degrees of reliability to the auditor, are:
- (a) documentary audit evidence created and held by third parties;
 - (b) documentary audit evidence created by third parties and held by the entity; and
 - (c) documentary audit evidence created and held by the entity.

Inspection of tangible assets provides reliable audit evidence with respect to their existence but not necessarily as to their ownership or value.

Observation

21. Observation consists of looking at a process or procedure being performed by others, for example, the observation by the auditor of the counting of inventories by the entity's personnel or the performance of control procedures that leave no audit trail.

Inquiry and Confirmation

22. Inquiry consists of seeking information of knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence.
23. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor ordinarily seeks direct confirmation of receivables by communication with debtors.

Computation

24. Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations.

Analytical Procedures

25. Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predicted amounts.

Public Sector Perspective

1. *When carrying out audits of public sector entities, the auditor will need to take into account the legislative framework and any other relevant regulations, ordinances or ministerial directives which affect the audit mandate and any special auditing requirements. Such requirements might affect, for example, the extent of the auditor's discretion in establishing materiality and judgments on the nature and scope of audit procedures to be applied. Paragraph 9 of this ISA has to be applied only after giving consideration to such restrictions on the auditor's judgment.*

INTERNATIONAL STANDARD ON AUDITING 501

AUDIT EVIDENCE—ADDITIONAL CONSIDERATIONS FOR SPECIFIC ITEMS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

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To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance additional to that contained in ISA 500 “Audit Evidence,” with respect to certain specific financial statement amounts and other disclosures.
2. Application of the standards and guidance provided in this ISA will assist the auditor in obtaining audit evidence with respect to the specific financial statement amounts and other disclosures addressed.
3. This ISA comprises the following parts:

Part	A:	Attendance at Physical Inventory Counting
Part	B:	Superceded by ISA 505—Part B has been deleted.
Part	C:	Inquiry Regarding Litigation and Claims
Part	D:	Valuation and Disclosure of Long-term Investments
Part	E:	Segment Information

PART A: ATTENDANCE AT PHYSICAL INVENTORY COUNTING

4. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements or to ascertain the reliability of the perpetual inventory system.
5. **When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable.** Such attendance will enable the auditor to inspect the inventory, to observe compliance with the operation of management's procedures for recording and controlling the results of the count and to provide evidence as to the reliability of management's procedures.
6. **If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and, when necessary, perform tests of intervening transactions.**
7. **Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope limitation.** For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.
8. In planning attendance at the physical inventory count or the alternative procedures, the auditor would consider:
 - The nature of the accounting and internal control systems used regarding inventory.
 - Inherent, control and detection risks, and materiality related to inventory.
 - Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
 - The timing of the count.
 - The locations at which inventory is held.
 - Whether an expert's assistance is needed.
9. When the quantities are to be determined by a physical inventory count and the auditor attends such a count, or when the entity operates a perpetual system and the auditor attends a count one or more times during the year, the auditor would ordinarily observe count procedures and perform test counts.

10. If the entity uses procedures to estimate the physical quantity, such as estimating a coal pile, the auditor would need to be satisfied regarding the reasonableness of those procedures.
11. When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the assessment of inherent and control risk at different locations.
12. The auditor would review management's instructions regarding:
 - (a) The application of control procedures, for example, collection of used stocksheets, accounting for unused stocksheets and count and re-count procedures;
 - (b) Accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment; and
 - (c) Whether appropriate arrangements are made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.
13. To obtain assurance that management's procedures are adequately implemented, the auditor would observe employees' procedures and perform test counts. When performing counts, the auditor would test both the completeness and the accuracy of the count records by tracing items selected from those records to the physical inventory and items selected from the physical inventory to the count records. The auditor would consider the extent to which copies of such count records need to be retained for subsequent testing and comparison.
14. The auditor would also consider cutoff procedures including details of the movement of inventory just prior to, during and after the count so that the accounting for such movements can be checked at a later date.
15. For practical reasons, the physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes only when control risk is assessed at less than high. The auditor would assess whether, through the performance of appropriate procedures, changes in inventory between the count date and period end are correctly recorded.
16. When the entity operates a perpetual inventory system which is used to determine the period end balance, the auditor would assess whether, through the performance of additional procedures, the reasons for any significant differences between the physical count and the perpetual inventory records are understood and the records are properly adjusted.
17. The auditor would test the final inventory listing to assess whether it accurately reflects actual inventory counts.

18. When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. Depending on materiality of this inventory the auditor would also consider:
- The integrity and independence of the third party.
 - Observing, or arranging for another auditor to observe, the physical inventory count.
 - Obtaining another auditor's report on the adequacy of the third party's accounting and internal control systems for ensuring that inventory is correctly counted and adequately safeguarded.
 - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts, or obtaining confirmation from other parties when such inventory has been pledged as collateral.

PART B: SUPERCEDED BY ISA 505—PART B (PARAGRAPHS 19-30) HAS BEEN DELETED.

PART C: INQUIRY REGARDING LITIGATION AND CLAIMS

31. Litigation and claims involving an entity may have a material effect on the financial statements and thus may be required to be disclosed and/or provided for in the financial statements.
32. **The auditor should carry out procedures in order to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements.** Such procedures would include:
- Make appropriate inquiries of management including obtaining representations.
 - Review board minutes and correspondence with the entity's lawyers.
 - Examine legal expense accounts.
 - Use any information obtained regarding the entity's business including information obtained from discussions with any in-house legal department.
33. **When litigation or claims have been identified or when the auditor believes they may exist, the auditor should seek direct communication with the entity's lawyers.** Such communication will assist in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable.
34. **The letter, which should be prepared by management and sent by the auditor, should request the lawyer to communicate directly with the**

auditor. When it is considered unlikely that the lawyer will respond to a general inquiry, the letter would ordinarily specify:

- A list of litigation and claims.
 - Management’s assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved.
 - A request that the lawyer confirm the reasonableness of management’s assessments and provide the auditor with further information if the list is considered by the lawyer to be incomplete or incorrect.
35. The auditor considers the status of legal matters up to the date of the audit report. In some instances, the auditor may need to obtain updated information from lawyers.
 36. In certain circumstances, for example, where the matter is complex or there is disagreement between management and the lawyer, it may be necessary for the auditor to meet with the lawyer to discuss the likely outcome of litigation and claims. Such meetings would take place with management’s permission and, preferably, with a representative of management in attendance.
 37. **If management refuses to give the auditor permission to communicate with the entity’s lawyers, this would be a scope limitation and should ordinarily lead to a qualified opinion or a disclaimer of opinion.** Where a lawyer refuses to respond in an appropriate manner and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative procedures, the auditor would consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.

PART D: VALUATION AND DISCLOSURE OF LONG-TERM INVESTMENTS

38. **When long-term investments are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding their valuation and disclosure.**
39. Audit procedures regarding long-term investments ordinarily include considering evidence as to whether the entity has the ability to continue to hold the investments on a long term basis and discussing with management whether the entity will continue to hold the investments as long-term investments and obtaining written representations to that effect.
40. Other procedures would ordinarily include considering related financial statements and other information, such as market quotations, which provide an indication of value and comparing such values to the carrying amount of the investments up to the date of the auditor’s report.
41. If such values do not exceed the carrying amounts, the auditor would consider whether a write-down is required. If there is an uncertainty as to whether the

carrying amount will be recovered, the auditor would consider whether appropriate adjustments and/or disclosures have been made.

PART E: SEGMENT INFORMATION

42. **When segment information is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its disclosure in accordance with the identified financial reporting framework.**
43. The auditor considers segment information in relation to the financial statements taken as a whole, and is not ordinarily required to apply auditing procedures that would be necessary to express an opinion on the segment information standing alone. However, the concept of materiality encompasses both quantitative and qualitative factors and the auditor's procedures recognize this.
44. Audit procedures regarding segment information ordinarily consist of analytical procedures and other audit tests appropriate in the circumstances.
45. The auditor would discuss with management the methods used in determining segment information, and consider whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework and test the application of such methods. The auditor would consider sales, transfers and charges between segments, elimination of inter-segment amounts, comparisons with budgets and other expected results, for example, operating profits as a percentage of sales, and the allocation of assets and costs among segments including consistency with prior periods and the adequacy of the disclosures with respect to inconsistencies.

INTERNATIONAL STANDARD ON AUDITING 505

EXTERNAL CONFIRMATIONS

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Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's use of external confirmations as a means of obtaining audit evidence.
2. **The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions.**
3. ISA 500 "Audit Evidence" states that the reliability of audit evidence is influenced by its source and nature. It indicates that, in general, audit evidence from external sources is more reliable than audit evidence generated internally, and that written audit evidence is more reliable than audit evidence in oral form. Accordingly, audit evidence in the form of written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other procedures, may assist in reducing audit risk for the related assertions to an acceptably low level.
4. External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmations the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.
5. External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so what the relevant details are. Other examples of situations where external confirmations may be used include the following.
 - Bank balances and other information from bankers.
 - Accounts receivable balances.
 - Stocks held by third parties at bonded warehouses for processing or on consignment.
 - Property title deeds held by lawyers or financiers for safe custody or as security.

- Investments purchased from stockbrokers but not delivered at the balance sheet date.
 - Loans from lenders.
 - Accounts payable balances.
6. The reliability of the evidence obtained by external confirmations depends, among other factors, upon the auditor applying appropriate procedures in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

Relationship of External Confirmation Procedures to the Auditor's Assessments of Inherent Risk and Control Risk

7. ISA 400 "Risk Assessments and Internal Control" discusses audit risk and the relationship between its components: inherent risk, control risk, and detection risk. It outlines the process of assessing inherent and control risk to determine the nature, timing, and extent of substantive procedures to reduce detection risk, and therefore audit risk, to an acceptable level.
8. ISA 400 also indicates that the nature and extent of evidence to be obtained from the performance of substantive procedures varies depending on the assessment of inherent and control risks, and that the assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need to perform any substantive procedures. These substantive procedures may include the use of external confirmations for specific financial statement assertions.
9. Paragraph 47 of ISA 400 indicates that the higher the assessment of inherent and control risk, the more audit evidence the auditor needs to obtain from the performance of substantive procedures. Consequently as the assessed level of inherent and control risk increases, the auditor designs substantive procedures to obtain more evidence, or more persuasive evidence, about a financial statement assertion. In these situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.
10. The lower the assessed level of inherent and control risk, the less assurance the auditor needs from substantive procedures to form a conclusion about a financial statement assertion. For example, an entity may have a loan that it is repaying according to an agreed schedule, the terms of which the auditor has confirmed in previous years. If the other work carried out by the auditor (including such tests of controls as are necessary) indicates that the terms of the loan have not changed and has lead to the level of inherent and control risk over the balance of the loan outstanding being assessed as low, the auditor

might limit substantive procedures to testing details of the payments made, rather than again confirming the balance directly with the lender.

11. Unusual or complex transactions may be associated with higher levels of inherent or control risk than simple transactions. If the entity has entered into an unusual or complex transaction and the level of inherent and control risk is assessed as high, the auditor considers confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity.

Assertions Addressed by External Confirmations

12. ISA 500 categorizes the management assertions embodied in financial statements as existence, rights and obligations, occurrence, completeness, valuation, measurement, and presentation and disclosure. While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide evidence relevant to a particular financial statement assertion varies.
13. External confirmation of an account receivable provides strong evidence regarding the existence of the account as at a certain date. Confirmation also provides evidence regarding the operation of cut-off procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.
14. Similarly, in the case of goods held on consignment, external confirmation is likely to provide strong evidence to support the existence and the rights and obligations assertions, but might not provide evidence that supports the valuation assertion.
15. The relevance of external confirmations to auditing a particular financial statement assertion is also affected by the objective of the auditor in selecting information for confirmation. For example, when auditing the completeness assertion for accounts payable, the auditor needs to obtain evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity's principal suppliers asking them to provide copies of their statements of account directly to the auditor, even if the records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.
16. When obtaining evidence for assertions not adequately addressed by confirmations, the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

Design of the External Confirmation Request

17. **The auditor should tailor external confirmation requests to the specific audit objective.** When designing the request, the auditor considers the

assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through external confirmation procedures.

18. Also, in designing the request, the auditor considers the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of the evidence obtained. For example, certain respondents' accounting systems may facilitate the external confirmation of single transactions rather than of entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.
19. Confirmation requests ordinarily include management's authorization to the respondent to disclose the information to the auditor. Respondents may be more willing to respond to a confirmation request containing management's authorization, and in some cases may be unable to respond unless the request contains management's authorization.

Use of Positive and Negative Confirmations

20. The auditor may use positive or negative external confirmation requests or a combination of both.
21. A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.
22. A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct. Accordingly, the use of negative confirmation requests ordinarily provides less reliable evidence than the use of positive confirmation requests, and the auditor considers performing other substantive procedures to supplement the use of negative confirmations.

23. Negative confirmation requests may be used to reduce audit risk to an acceptable level when:
- (a) The assessed level of inherent and control risk is low;
 - (b) A large number of small balances is involved;
 - (c) A substantial number of errors is not expected; and
 - (d) The auditor has no reason to believe that respondents will disregard these requests.
24. A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

Management Requests

25. **When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management's requests. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.**
26. **If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report.**
27. When considering the reasons provided by management, the auditor applies an attitude of professional skepticism and considers whether the request has any implications regarding management's integrity. The auditor considers whether management's request may indicate the possible existence of fraud or error. If the auditor believes that fraud or error exists, the auditor applies the guidance in ISA 240 "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements." The auditor also considers whether the alternative procedures will provide sufficient appropriate evidence regarding that matter.

Characteristics of Respondents

28. The reliability of evidence provided by a confirmation is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed

to an appropriate individual. For example, when confirming that a covenant related to an entity's long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.

29. The auditor also assesses whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent's competence, knowledge, motivation, ability or willingness to respond may come to the auditor's attention. The auditor considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional procedures are necessary. The auditor also considers whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect a response that will provide sufficient appropriate evidence. For example, the auditor may encounter significant unusual year-end transactions that have a material effect on the financial statements, the transactions being with a third party that is economically dependent upon the entity. In such circumstances, the auditor considers whether the third party may be motivated to provide an inaccurate response.

The External Confirmation Process

30. **When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests.** Control is maintained over communications between the intended recipients and the auditor to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor ensures that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies are sent directly to the auditor. The auditor considers whether replies have come from the purported senders.

No Response to a Positive Confirmation Request

31. **The auditor should perform alternative procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide the evidence about the financial statement assertions that the confirmation request was intended to provide.**
32. Where no response is received, the auditor ordinarily contacts the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor uses alternative audit procedures. The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative procedures may include examination of subsequent cash receipts, examination of shipping

documentation or other client documentation to provide evidence for the existence assertion, and sales cut off tests to provide evidence for the completeness assertion. In the examination of accounts payable, alternative procedures may include examination of subsequent cash disbursements or correspondence from third parties to provide evidence of the existence assertion, and examination of other records, such as goods received notes, to provide evidence of the completeness assertion.

Reliability of Responses Received

33. The auditor considers whether there is any indication that external confirmations received may not be reliable. The auditor considers the response's authenticity and performs procedures to dispel any concern. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor requests the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor considers validating the source of replies received in electronic format (for example, fax or electronic mail). Oral confirmations are documented in the work papers. If the information in the oral confirmations is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor.

Causes and Frequency of Exceptions

34. **When the auditor forms a conclusion that the confirmation process and alternative procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should undertake additional procedures to obtain sufficient appropriate audit evidence.**

In forming the conclusion, the auditor considers the:

- (a) Reliability of the confirmations and alternative procedures;
- (b) Nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and
- (c) Evidence provided by other procedures.

Based on this evaluation, the auditor determines whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

35. The auditor also considers the causes and frequency of exceptions reported by respondents. An exception may indicate a misstatement in the entity's records, in which case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor reconsiders the nature, timing and extent of audit procedures necessary to provide the evidence required.

Evaluating the Results of the Confirmation Process

36. **The auditor should evaluate whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial statement assertion being audited.** In conducting this evaluation the auditor considers the guidance provided by ISA 530, “Audit Sampling and Other Selective Procedures.”

External Confirmations Prior to the Year-End

37. When the auditor uses confirmation as at a date prior to the balance sheet to obtain evidence to support a financial statement assertion, the auditor obtains sufficient appropriate audit evidence that transactions relevant to the assertion in the intervening period have not been materially misstated. For practical reasons when the level of inherent and control risk is assessed at less than high, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance sheet date. As with all types of pre-year-end work, the auditor considers the need to obtain further audit evidence relating to the remainder of the period.

Effective Date

38. This ISA is effective for audits of financial statements for periods ending on or after December 31, 2001.

INTERNATIONAL STANDARD ON AUDITING 510

INITIAL ENGAGEMENTS—OPENING BALANCES

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance regarding opening balances when the financial statements are audited for the first time or when the financial statements for the prior period were audited by another auditor. This ISA would also be considered so the auditor may become aware of contingencies and commitments existing at the beginning of the period. Guidance on the audit and reporting requirements regarding comparatives is provided in ISA 710 “Comparatives.”
2. **For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:**
 - (a) **The opening balances do not contain misstatements that materially affect the current period’s financial statements;**
 - (b) **The prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, have been restated; and**
 - (c) **Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately disclosed.**
3. “Opening balances” means those account balances which exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of:
 - (a) Transactions of prior periods; and
 - (b) Accounting policies applied in the prior period.

In an initial audit engagement, the auditor will not have previously obtained audit evidence supporting such opening balances.

Audit Procedures

4. The sufficiency and appropriateness of the audit evidence the auditor will need to obtain regarding opening balances depends on such matters as:
 - The accounting policies followed by the entity.
 - Whether the prior period’s financial statements were audited, and if so whether the auditor’s report was modified.
 - The nature of the accounts and the risk of misstatement in the current period’s financial statements.
 - The materiality of the opening balances relative to the current period’s financial statements.

5. The auditor will need to consider whether opening balances reflect the application of appropriate accounting policies and that those policies are consistently applied in the current period's financial statements. When there are any changes in the accounting policies or application thereof, the auditor would consider whether they are appropriate and properly accounted for and adequately disclosed.
6. When the prior period's financial statements were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by reviewing the predecessor auditor's working papers. In these circumstances, the current auditor would also consider the professional competence and independence of the predecessor auditor. If the prior period's auditor's report was modified, the auditor would pay particular attention in the current period to the matter which resulted in the modification.
7. Prior to communicating with the predecessor auditor, the current auditor will need to consider the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.
8. When the prior period's financial statements were not audited or when the auditor is not able to be satisfied by using the procedures described in paragraph 6, the auditor will need to perform other procedures such as those discussed in paragraphs 9 and 10.
9. For current assets and liabilities some audit evidence can ordinarily be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, it is more difficult for the auditor to be satisfied as to inventory on hand at the beginning of the period. Therefore, additional procedures are ordinarily necessary such as observing a current physical inventory taking and reconciling it back to the opening inventory quantities, testing the valuation of the opening inventory items, and testing gross profit and cutoff. A combination of these procedures may provide sufficient appropriate audit evidence.
10. For noncurrent assets and liabilities, such as fixed assets, investments and long-term debt, the auditor will ordinarily examine the records underlying the opening balances. In certain cases, the auditor may be able to obtain confirmation of opening balances with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

11. **If, after performing procedures including those set out above, the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor's report should include:**

(a) **A qualified opinion**, for example:

“We did not observe the counting of the physical inventory stated at XXX as at December 31, 19X1, since that date was prior to our appointment as auditors. We were unable to satisfy ourselves as to the inventory quantities at that date by other audit procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to observe the counting of physical inventory and satisfy ourselves as to the opening balance of inventory, the financial statements give a true and fair view of (present fairly, in all material respects,) the financial position of ... as at December 31, 19X2 and the results of its operations and its cash flows for the year then ended in accordance with ...;”

(b) **A disclaimer of opinion**; or(c) **In those jurisdictions where it is permitted, an opinion which is qualified or disclaimed regarding the results of operations and unqualified regarding financial position**, for example:

“We did not observe the counting of the physical inventory stated at XXX as at December 31, 19X1, since that date was prior to our appointment as auditors. We were unable to satisfy ourselves as to the inventory quantities at that date by other audit procedures.

Because of the significance of the above matter in relation to the results of the Company’s operations for the year to December 31, 19X2, we are not in a position to, and do not, express an opinion on the results of its operations and its cash flows for the year then ended.

In our opinion, the balance sheet gives a true and fair view of (or ‘presents fairly in all material respects,’) the financial position of the Company as at December 31, 19X2, in accordance with”

12. If the opening balances contain misstatements which could materially affect the current period’s financial statements, the auditor would inform management and, after having obtained management’s authorization, the predecessor auditor, if any. **If the effect of the misstatement is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.**
13. **If the current period’s accounting policies have not been consistently applied in relation to opening balances and if the change has not been properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion as appropriate.**
14. If the entity’s prior period auditor’s report was modified, the auditor would consider the effect thereof on the current period’s financial statements. For example, if there was a scope limitation, such as one due to the inability to determine opening inventory in the prior period, the auditor may not need to

qualify or disclaim the current period's audit opinion. **However, if a modification regarding the prior period's financial statements remains relevant and material to the current period's financial statements, the auditor should modify the current auditor's report accordingly.**

INTERNATIONAL STANDARD ON AUDITING 520

ANALYTICAL PROCEDURES

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the application of analytical procedures during an audit.
2. **The auditor should apply analytical procedures at the planning and overall review stages of the audit.** Analytical procedures may also be applied at other stages.
3. “Analytical procedures” means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predicted amounts.

Nature and Purpose of Analytical Procedures

4. Analytical procedures include the consideration of comparisons of the entity’s financial information with, for example:
 - Comparable information for prior periods.
 - Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
 - Similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
5. Analytical procedures also include consideration of relationships:
 - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages.
 - Between financial information and relevant non-financial information, such as payroll costs to number of employees.
6. Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information. The auditor’s choice of procedures, methods and level of application is a matter of professional judgment.
7. Analytical procedures are used for the following purposes:
 - (a) To assist the auditor in planning the nature, timing and extent of other audit procedures;

- (b) As substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and
- (c) As an overall review of the financial statements in the final review stage of the audit.

Analytical Procedures in Planning the Audit

- 8. **The auditor should apply analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk.** Application of analytical procedures may indicate aspects of the business of which the auditor was unaware and will assist in determining the nature, timing and extent of other audit procedures.
- 9. Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical Procedures as Substantive Procedures

- 10. The auditor's reliance on substantive procedures to reduce detection risk relating to specific financial statement assertions may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to achieve a particular audit objective is based on the auditor's judgment about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statement assertions.
- 11. The auditor will ordinarily inquire of management as to the availability and reliability of information needed to apply analytical procedures and the results of any such procedures performed by the entity. It may be efficient to use analytical data prepared by the entity, provided the auditor is satisfied that such data is properly prepared.
- 12. When intending to perform analytical procedures as substantive procedures, the auditor will need to consider a number of factors such as the:
 - Objectives of the analytical procedures and the extent to which their results can be relied upon (paragraphs 14 - 16).
 - Nature of the entity and the degree to which information can be disaggregated, for example, analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
 - Availability of information, both financial, such as budgets or forecasts, and nonfinancial, such as the number of units produced or sold.

- Reliability of the information available, for example, whether budgets are prepared with sufficient care.
- Relevance of the information available for example, whether budgets have been established as results to be expected rather than as goals to be achieved.
- Source of the information available, for example, sources independent of the entity are ordinarily more reliable than internal sources.
- Comparability of the information available, for example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products.
- Knowledge gained during previous audits, together with the auditor's understanding of the effectiveness of the accounting and internal control systems and the types of problems that in prior periods have given rise to accounting adjustments.

Analytical Procedures in the Overall Review at the End of the Audit

13. **The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business.** The conclusions drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, they may also identify areas requiring further procedures.

Extent of Reliance on Analytical Procedures

14. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.
15. The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:
 - Materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

- Other audit procedures directed toward the same audit objectives for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an aging of customers' accounts;
 - Accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and
 - Assessments of inherent and control risks, for example, if internal control over sales order processing is weak and therefore control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.
16. The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

Investigating Unusual Items

17. **When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.**
18. The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:
- (a) Corroboration of management's responses, for example, by comparing them with the auditor's knowledge of the business and other evidence obtained during the course of the audit; and
 - (b) Consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

Public Sector Perspective

1. *The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be appropriate in the audit of governments or other non-business public sector entities; for example, in many such public sector entities there is often little direct relationship between revenues and expenditures. In addition, because expenditure on the acquisition of assets is frequently noncapitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. In addition, in the public sector, industry data or statistics for comparative purposes may not be available. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired. Where appropriate, reference has to be made to available private sector industry data and statistics. In certain instances, it may also be appropriate for the auditor to generate an in-house database of reference information.*

INTERNATIONAL STANDARD ON AUDITING 530

AUDIT SAMPLING AND OTHER SELECTIVE TESTING PROCEDURES

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Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the use of audit sampling procedures and other means of selecting items for testing to gather audit evidence.
2. **When designing audit procedures, the auditor should determine appropriate means for selecting items for testing so as to gather audit evidence to meet the objectives of audit tests.**

Definitions

3. “Audit sampling” (sampling) involves the application of audit procedures to less than 100% of items within an account balance or class of transactions such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can use either a statistical or a non-statistical approach.
4. For purposes of this ISA, “error” means either control deviations, when performing tests of control, or misstatements, when performing substantive procedures. Similarly, total error is used to mean either the rate of deviation or total misstatement.
5. “Anomalous error” means an error that arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of errors in the population.
6. “Population” means the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. For example, all of the items in an account balance or a class of transactions constitute a population. A population may be divided into strata, or sub-populations, with each stratum being examined separately. The term population is used to include the term stratum.
7. “Sampling risk” arises from the possibility that the auditor’s conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure. There are two types of sampling risk:
 - (a) The risk the auditor will conclude, in the case of a test of control, that control risk is lower than it actually is, or in the case of a substantive test, that a material error does not exist when in fact it does. This type of risk affects audit effectiveness and is more likely to lead to an inappropriate audit opinion; and
 - (b) The risk the auditor will conclude, in the case of a test of control, that control risk is higher than it actually is, or in the case of a substantive test, that a material error exists when in fact it does not. This type of risk

affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

The mathematical complements of these risks are termed confidence levels.

8. “Non-sampling risk” arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, most audit evidence is persuasive rather than conclusive, the auditor might use inappropriate procedures, or the auditor might misinterpret evidence and fail to recognize an error.
9. “Sampling unit” means the individual items constituting a population, for example checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors’ balances, or a monetary unit.
10. “Statistical sampling” means any approach to sampling that has the following characteristics:
 - (a) Random selection of a sample; and
 - (b) Use of probability theory to evaluate sample results, including measurement of sampling risk.A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.
11. “Stratification” is the process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).
12. “Tolerable error” means the maximum error in a population that the auditor is willing to accept.

Audit Evidence

13. In accordance with ISA 500 “Audit Evidence”, audit evidence is obtained from an appropriate mix of tests of control and substantive procedures. The type of test to be performed is important to an understanding of the application of audit procedures in gathering audit evidence.

Tests of Control

14. In accordance with ISA 400 “Risk Assessments and Internal Control” tests of control are performed if the auditor plans to assess control risk less than high for a particular assertion.
15. Based on the auditor’s understanding of the accounting and internal control systems, the auditor identifies the characteristics or attributes that indicate performance of a control, as well as possible deviation conditions which indicate departures from adequate performance. The presence or absence of attributes can then be tested by the auditor.

16. Audit sampling for tests of control is generally appropriate when application of the control leaves evidence of performance (for example, initials of the credit manager on a sales invoice indicating credit approval, or evidence of authorization of data input to a microcomputer based data processing system).

Substantive Procedures

17. Substantive procedures are concerned with amounts and are of two types: analytical procedures and tests of details of transactions and balances. The purpose of substantive procedures is to obtain audit evidence to detect material misstatements in the financial statements. When performing substantive tests of details, audit sampling and other means of selecting items for testing and gathering audit evidence may be used to verify one or more assertions about a financial statement amount (for example, the existence of accounts receivable), or to make an independent estimate of some amount (for example, the value of obsolete inventories).

Risk Considerations in Obtaining Evidence

18. **In obtaining evidence, the auditor should use professional judgment to assess audit risk and design audit procedures to ensure this risk is reduced to an acceptably low level.**
19. Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk consists of inherent risk – the susceptibility of an account balance to material misstatement, assuming there are no related internal controls; control risk - the risk that a material misstatement will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems; and, detection risk – the risk that the material misstatements will not be detected by the auditor's substantive procedures. These three components of audit risk are considered during the planning process in the design of audit procedures in order to reduce audit risk to an acceptably low level.
20. Sampling risk and non-sampling risk can affect the components of audit risk. For example, when performing tests of control, the auditor may find no errors in a sample and conclude that control risk is low, when the rate of error in the population is, in fact, unacceptably high (sampling risk). Or there may be errors in the sample which the auditor fails to recognize (non-sampling risk). With respect to substantive procedures, the auditor may use a variety of methods to reduce detection risk to an acceptable level. Depending on their nature, these methods will be subject to sampling and/or non-sampling risks. For example, the auditor may choose an inappropriate analytical procedure (non-sampling risk) or may find only minor misstatements in a test of details when, in fact, the population misstatement is greater than the tolerable amount (sampling risk). For both tests of control and substantive tests, sampling risk can be reduced by increasing sample size, while non-sampling risk can be reduced by proper engagement planning, supervision, and review.

Procedures for Obtaining Evidence

21. Procedures for obtaining audit evidence include inspection, observation, inquiry and confirmation, computation and analytical procedures. The choice of appropriate procedures is a matter of professional judgment in the circumstances. Application of these procedures will often involve the selection of items for testing from a population.

Selecting Items for Testing to Gather Audit Evidence

22. **When designing audit procedures, the auditor should determine appropriate means of selecting items for testing.** The means available to the auditor are:
 - (a) Selecting all items (100% examination);
 - (b) Selecting specific items, and
 - (c) Audit sampling.
23. The decision as to which approach to use will depend on the circumstances, and the application of any one or combination of the above means may be appropriate in particular circumstances. While the decision as to which means, or combination of means, to use is made on the basis of audit risk and audit efficiency, the auditor needs to be satisfied that methods used are effective in providing sufficient appropriate audit evidence to meet the objectives of the test.

Selecting all items

24. The auditor may decide that it will be most appropriate to examine the entire population of items that make up an account balance or class of transactions (or a stratum within that population). 100% examination is unlikely in the case of tests of control; however, it is more common for substantive procedures. For example, 100% examination may be appropriate when the population constitutes a small number of large value items, when both inherent and control risks are high and other means do not provide sufficient appropriate audit evidence, or when the repetitive nature of a calculation or other process performed by a computer information system makes a 100% examination cost effective.

Selecting Specific Items

25. The auditor may decide to select specific items from a population based on such factors as knowledge of the client's business, preliminary assessments of inherent and control risks, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- *High value or key items.* The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example items that are suspicious, unusual, particularly risk-prone or that have a history of error.
 - *All items over a certain amount.* The auditor may decide to examine items whose values exceed a certain amount so as to verify a large proportion of the total amount of an account balance or class of transactions.
 - *Items to obtain information.* The auditor may examine items to obtain information about matters such as the client's business, the nature of transactions, accounting and internal control systems.
 - *Items to test procedures.* The auditor may use judgment to select and examine specific items to determine whether or not a particular procedure is being performed.
26. While selective examination of specific items from an account balance or class of transactions will often be an efficient means of gathering audit evidence, it does not constitute audit sampling. The results of procedures applied to items selected in this way cannot be projected to the entire population. The auditor considers the need to obtain appropriate evidence regarding the remainder of the population when that remainder is material.

Audit Sampling

27. The auditor may decide to apply audit sampling to an account balance or class of transactions. Audit sampling can be applied using either non-statistical or statistical sampling methods. Audit sampling is discussed in detail in paragraphs 31–56.

Statistical versus Non-Statistical Sampling Approaches

28. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment regarding the most efficient manner to obtain sufficient appropriate audit evidence in the particular circumstances. For example, in the case of tests of control the auditor's analysis of the nature and cause of errors will often be more important than the statistical analysis of the mere presence or absence (that is, the count) of errors. In such a situation, non-statistical sampling may be most appropriate.
29. When applying statistical sampling, the sample size can be determined using either probability theory or professional judgment. Moreover, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches. Sample size is a function of factors such as those identified in Appendices 1 and 2. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 1 and 2 will be similar regardless of whether a statistical or non-statistical approach is chosen.

30. Often, while the approach adopted does not meet the definition of statistical sampling, elements of a statistical approach are used, for example the use of random selection using computer generated random numbers. However, only when the approach adopted has the characteristics of statistical sampling are statistical measurements of sampling risk valid.

Design of the Sample

31. **When designing an audit sample, the auditor should consider the objectives of the test and the attributes of the population from which the sample will be drawn.**
32. The auditor first considers the specific objectives to be achieved and the combination of audit procedures which is likely to best achieve those objectives. Consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling.
33. The auditor considers what conditions constitute an error by reference to the objectives of the test. A clear understanding of what constitutes an error is important to ensure that all, and only, those conditions that are relevant to the test objectives are included in the projection of errors. For example, in a substantive procedure relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client are not considered an error. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it is not appropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the likelihood of fraud or the adequacy of the allowance for doubtful accounts.
34. When performing tests of control, the auditor generally makes a preliminary assessment of the rate of error the auditor expects to find in the population to be tested and the level of control risk. This assessment is based on the auditor's prior knowledge or the examination of a small number of items from the population. Similarly, for substantive tests, the auditor generally makes a preliminary assessment of the amount of error in the population. These preliminary assessments are useful for designing an audit sample and in determining sample size. For example, if the expected rate of error is unacceptably high, tests of control will normally not be performed. However, when performing substantive procedures, if the expected amount of error is high, 100% examination or the use of a large sample size may be appropriate.

Population

35. It is important for the auditor to ensure that the population is:

- (a) *Appropriate* to the objective of the sampling procedure, which will include consideration of the direction of testing. For example, if the auditor's objective is to test for overstatement of accounts payable, the population could be defined as the accounts payable listing. On the other hand, when testing for understatement of accounts payable, the population is not the accounts payable listing but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports or other populations that provide audit evidence of understatement of accounts payable; and
- (b) *Complete*. For example, if the auditor intends to select payment vouchers from a file, conclusions cannot be drawn about all vouchers for the period unless the auditor is satisfied that all vouchers have in fact been filed. Similarly, if the auditor intends to use the sample to draw conclusions about the operation of an accounting and internal control system during the financial reporting period, the population needs to include all relevant items from throughout the entire period. A different approach may be to stratify the population and use sampling only to draw conclusions about the control during, say, the first 10 months of a year, and to use alternative procedures or a separate sample regarding the remaining two months.

Stratification

- 36. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without a proportional increase in sampling risk. Sub-populations need to be carefully defined such that any sampling unit can only belong to one stratum.
- 37. When performing substantive procedures, an account balance or class of transactions is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items which may contain the greatest potential monetary error in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of error, for example, when testing the valuation of accounts receivable, balances may be stratified by age.
- 38. The results of procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider risk and materiality in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering evidence will be used, or which may be considered immaterial).

Value Weighted Selection

39. It will often be efficient in substantive testing, particularly when testing for overstatements, to identify the sampling unit as the individual monetary units (e.g., dollars) that make up an account balance or class of transactions. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor then examines the particular items, for example, individual balances, that contain those monetary units. This approach to defining the sampling unit ensures that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes. This approach is ordinarily used in conjunction with the systematic method of sample selection (described in Appendix 3) and is most efficient when selecting from a computerized database.

Sample Size

40. **In determining the sample size, the auditor should consider whether sampling risk is reduced to an acceptably low level.** Sample size is affected by the level of sampling risk that the auditor is willing to accept. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.
41. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment objectively applied to the circumstances. Appendices 1 and 2 indicate the influences that various factors typically have on the determination of sample size, and hence the level of sampling risk.

Selecting the Sample

42. **The auditor should select items for the sample with the expectation that all sampling units in the population have a chance of selection.** Statistical sampling requires that sample items are selected at random so that each sampling unit has a known chance of being selected. The sampling units might be physical items (such as invoices) or monetary units. With non-statistical sampling, an auditor uses professional judgment to select the items for a sample. Because the purpose of sampling is to draw conclusions about the entire population, the auditor endeavors to select a representative sample by choosing sample items which have characteristics typical of the population, and the sample needs to be selected so that bias is avoided.
43. The principal methods of selecting samples are the use of random number tables or computer programs, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 3.

Performing the Audit Procedure

44. **The auditor should perform audit procedures appropriate to the particular test objective on each item selected.**

45. If a selected item is not appropriate for the application of the procedure, the procedure is ordinarily performed on a replacement item. For example, a voided check may be selected when testing for evidence of payment authorization. If the auditor is satisfied that the check had been properly voided such that it does not constitute an error, an appropriately chosen replacement is examined.
46. Sometimes however, the auditor is unable to apply the planned audit procedures to a selected item because, for instance, documentation relating to that item has been lost. If suitable alternative procedures cannot be performed on that item, the auditor ordinarily considers that item to be in error. An example of a suitable alternative procedure might be the examination of subsequent receipts when no reply has been received in response to a positive confirmation request.

Nature and Cause of Errors

47. **The auditor should consider the sample results, the nature and cause of any errors identified, and their possible effect on the particular test objective and on other areas of the audit.**
48. When conducting tests of control, the auditor is primarily concerned with the design and operation of the controls themselves and the assessment of control risk. However, when errors are identified, the auditor also needs to consider matters such as:
 - (a) The direct effect of identified errors on the financial statements; and
 - (b) The effectiveness of the accounting and internal control systems and their effect on the audit approach when, for example, the errors result from management override of an internal control.
49. In analyzing the errors discovered, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures in that stratum. In addition, such errors may be intentional, and may indicate the possibility of fraud.
50. Sometimes, the auditor may be able to establish that an error arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of similar errors in the population (an anomalous error). To be considered an anomalous error, the auditor has to have a high degree of certainty that such error is not representative of the population. The auditor obtains this certainty by performing additional work. The additional work depends on the situation, but is adequate to provide the auditor with sufficient appropriate evidence that the error does not affect the remaining part of the population. One example is an error caused by a computer breakdown that is known to have occurred on only one day during the period. In that case, the auditor assesses the effect of the breakdown, for

example by examining specific transactions processed on that day, and considers the effect of the cause of the breakdown on audit procedures and conclusions. Another example is an error that is found to be caused by use of an incorrect formula in calculating all inventory values at one particular branch. To establish that this is an anomalous error, the auditor needs to ensure the correct formula has been used at other branches.

Projecting Errors

51. **For substantive procedures, the auditor should project monetary errors found in the sample to the population, and should consider the effect of the projected error on the particular test objective and on other areas of the audit.** The auditor projects the total error for the population to obtain a broad view of the scale of errors, and to compare this to the tolerable error. For substantive procedures, tolerable error is the tolerable misstatement, and will be an amount less than or equal to the auditor's preliminary estimate of materiality used for the individual account balances being audited.
52. When an error has been established as an anomalous error, it may be excluded when projecting sample errors to the population. The effect of any such error, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous errors. If an account balance or class of transactions has been divided into strata, the error is projected for each stratum separately. Projected errors plus anomalous errors for each stratum are then combined when considering the possible effect of errors on the total account balance or class of transactions.
53. For tests of control, no explicit projection of errors is necessary since the sample error rate is also the projected rate of error for the population as a whole.

Evaluating the Sample Results

54. **The auditor should evaluate the sample results to determine whether the preliminary assessment of the relevant characteristic of the population is confirmed or needs to be revised.** In the case of a test of controls, an unexpectedly high sample error rate may lead to an increase in the assessed level of control risk, unless further evidence substantiating the initial assessment is obtained. In the case of a substantive procedure, an unexpectedly high error amount in a sample may cause the auditor to believe that an account balance or class of transactions is materially misstated, in the absence of further evidence that no material misstatement exists.
55. If the total amount of projected error plus anomalous error is less than but close to that which the auditor deems tolerable, the auditor considers the persuasiveness of the sample results in the light of other audit procedures, and may consider it appropriate to obtain additional audit evidence. The total of projected error plus anomalous error is the auditor's best estimate of error in the population. However, sampling results are affected by sampling risk. Thus

when the best estimate of error is close to the tolerable error, the auditor recognizes the risk that a different sample would result in a different best estimate that could exceed the tolerable error. Considering the results of other audit procedures helps the auditor to assess this risk, while the risk is reduced if additional audit evidence is obtained.

56. If the evaluation of sample results indicates that the preliminary assessment of the relevant characteristic of the population needs to be revised, the auditor may:
- (a) Request management to investigate identified errors and the potential for further errors, and to make any necessary adjustments; and/or
 - (b) Modify planned audit procedures. For example, in the case of a test of control, the auditor might extend the sample size, test an alternative control or modify related substantive procedures; and/or
 - (c) Consider the effect on the audit report.

Effective date

57. This ISA is effective for audits of financial statements for periods ending on or after July 1, 1999. Earlier application is permitted.

Appendix 1**Examples of Factors Influencing Sample Size for Tests of Control**

The following are factors that the auditor considers when determining the sample size for a test of control. These factors need to be considered together.

FACTOR	EFFECT ON SAMPLE SIZE
An increase in the auditor's intended reliance on accounting and internal control systems	Increase
An increase in the rate of deviation from the prescribed control procedure that the auditor is willing to accept	Decrease
An increase in the rate of deviation from the prescribed control procedure that the auditor expects to find in the population	Increase
An increase in the auditor's required confidence level (or conversely, a decrease in the risk that the auditor will conclude that the control risk is lower than the actual control risk in the population)	Increase
An increase in the number of sampling units in the population	Negligible effect

1. *The auditor's intended reliance on accounting and internal control systems:* The more assurance the auditor intends to obtain from accounting and internal control systems, the lower the auditor's assessment of control risk will be, and the larger the sample size will need to be. For example, a preliminary assessment of control risk as low indicates that the auditor plans to place considerable reliance on the effective operation of particular internal controls. The auditor therefore needs to gather more audit evidence to support this assessment than would be the case if control risk were assessed at a higher level (that is, if less reliance were planned).
2. *The rate of deviation from the prescribed control procedure the auditor is willing to accept (tolerable error).* The lower the rate of deviation that the auditor is willing to accept, the larger the sample size needs to be.
3. *The rate of deviation from the prescribed control procedure the auditor expects to find in the population (expected error).* The higher the rate of deviation that the auditor expects, the larger the sample size needs to be so as to be in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected error rate include the auditor's understanding of the business (in particular, procedures undertaken to obtain an understanding of the accounting and internal control systems), changes in personnel or in the accounting and internal control systems, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected error rates ordinarily warrant little, if any, reduction of control risk, and therefore in such circumstances tests of controls would ordinarily be omitted.
4. *The auditor's required confidence level.* The greater the degree of confidence that the auditor requires that the results of the sample are in fact indicative of the actual incidence of error in the population, the larger the sample size needs to be.
5. *The number of sampling units in the population.* For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Appendix 2**Examples of Factors Influencing Sample Size for Substantive Procedures**

The following are factors that the auditor considers when determining the sample size for a substantive procedure. These factors need to be considered together.

FACTOR	EFFECT ON SAMPLE SIZE
An increase in the auditor's assessment of inherent risk	Increase
An increase in the auditor's assessment of control risk	Increase
An increase in the use of other substantive procedures directed at the same financial statement assertion	Decrease
An increase in the auditor's required confidence level (or conversely, a decrease in the risk that the auditor will conclude that a material error does not exist, when in fact it does exist)	Increase
An increase in the total error that the auditor is willing to accept (tolerable error)	Decrease
An increase in the amount of error the auditor expects to find in the population	Increase
Stratification of the population when appropriate	Decrease
The number of sampling units in the population	Negligible Effect

1. *The auditor's assessment of inherent risk.* The higher the auditor's assessment of inherent risk, the larger the sample size needs to be. Higher inherent risk implies that a lower detection risk is needed to reduce the audit risk to an acceptable low level, and lower detection risk can be obtained by increasing sample size.
2. *The auditor's assessment of control risk.* The higher the auditor's assessment of control risk, the larger the sample size needs to be. For example, an assessment of control risk as high indicates that the auditor cannot place much reliance on the effective operation of internal controls with respect to the particular financial statement assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive tests. The more reliance that is placed on substantive tests (that is, the lower the detection risk), the larger the sample size will need to be.
3. *The use of other substantive procedures directed at the same financial statement assertion.* The more the auditor is relying on other substantive procedures (tests of detail or analytical procedures) to reduce to an acceptable level the detection risk regarding a particular account balance or class of transactions, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.
4. *The auditor's required confidence level.* The greater the degree of confidence that the auditor requires that the results of the sample are in fact indicative of the actual amount of error in the population, the larger the sample size needs to be.
5. *The total error the auditor is willing to accept (tolerable error).* The lower the total error that the auditor is willing to accept, the larger the sample size needs to be.
6. *The amount of error the auditor expects to find in the population (expected error).* The greater the amount of error the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of error in the population. Factors relevant to the auditor's consideration of the expected error amount include the extent to which item values are determined subjectively, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.
7. *Stratification.* When there is a wide range (variability) in the monetary size of items in the population. It may be useful to group items of similar size into separate sub-populations or strata. This is referred to as stratification. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

8. *The number of sampling units in the population.* For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality.)

Appendix 3

Sample Selection Methods

The principal methods of selecting samples are:

- (a) Use of a computerized random number generator or random number tables.
- (b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- (c) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
- (d) Block selection involves selecting a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

INTERNATIONAL STANDARD ON AUDITING 540

AUDIT OF ACCOUNTING ESTIMATES

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the audit of accounting estimates contained in financial statements. This ISA is not intended to be applicable to the examination of prospective financial information, though many of the procedures outlined herein may be suitable for that purpose.
2. **The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.**
3. “Accounting estimate” means an approximation of the amount of an item in the absence of a precise means of measurement. Examples are:
 - Allowances to reduce inventory and accounts receivable to their estimated realizable value.
 - Provisions to allocate the cost of fixed assets over their estimated useful lives.
 - Accrued revenue.
 - Deferred tax.
 - Provision for a loss from a lawsuit.
 - Losses on construction contracts in progress.
 - Provision to meet warranty claims.
4. Management is responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgment. As a result, the risk of material misstatement is greater when accounting estimates are involved.

The Nature of Accounting Estimates

5. The determination of an accounting estimate may be simple or complex depending upon the nature of the item. For example, accruing a charge for rent may be a simple calculation, whereas estimating a provision for slow-moving or surplus inventory may involve considerable analyses of current data and a forecast of future sales. In complex estimates, there may be a high degree of special knowledge and judgment required.
6. Accounting estimates may be determined as part of the routine accounting system operating on a continuing basis, or may be nonroutine, operating only at period end. In many cases, accounting estimates are made by using a formula based on experience, such as the use of standard rates for depreciating each category of fixed assets or a standard percentage of sales revenue for computing a warranty provision. In such cases, the formula needs to be reviewed regularly by management, for example, by reassessing the remaining

useful lives of assets or by comparing actual results with the estimate and adjusting the formula when necessary.

7. The uncertainty associated with an item, or the lack of objective data may make it incapable of reasonable estimation, in which case, the auditor needs to consider whether the auditor's report needs modification to comply with ISA 700 "The Auditor's Report on Financial Statements."

Audit Procedures

8. **The auditor should obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances and, when required, is appropriately disclosed.** The evidence available to support an accounting estimate will often be more difficult to obtain and less conclusive than evidence available to support other items in the financial statements.
9. An understanding of the procedures and methods, including the accounting and internal control systems, used by management in making the accounting estimates is often important for the auditor to plan the nature, timing and extent of the audit procedures.
10. **The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:**
 - (a) **Review and test the process used by management to develop the estimate;**
 - (b) **Use an independent estimate for comparison with that prepared by management; or**
 - (c) **Review subsequent events which confirm the estimate made.**

Reviewing and Testing the Process Used by Management

11. The steps ordinarily involved in reviewing and testing of the process used by management are:
 - (a) Evaluation of the data and consideration of assumptions on which the estimate is based;
 - (b) Testing of the calculations involved in the estimate;
 - (c) Comparison, when possible, of estimates made for prior periods with actual results of those periods; and
 - (d) Consideration of management's approval procedures.

Evaluation of Data and Consideration of Assumptions

12. The auditor would evaluate whether the data on which the estimate is based is accurate, complete and relevant. When accounting data is used, it will need to be consistent with the data processed through the accounting system. For

example, in substantiating a warranty provision, the auditor would obtain audit evidence that the data relating to products still within the warranty period at period end agree with the sales information within the accounting system.

13. The auditor may also seek evidence from sources outside the entity. For example, when examining a provision for inventory obsolescence calculated by reference to anticipated future sales, the auditor may, in addition to examining internal data such as past levels of sales, orders on hand and marketing trends, seek evidence from industry-produced sales projections and market analyses. Similarly, when examining management's estimates of the financial implications of litigation and claims, the auditor would seek direct communication with the entity's lawyers.
14. The auditor would evaluate whether the data collected is appropriately analyzed and projected to form a reasonable basis for determining the accounting estimate. Examples are the analysis of the age of accounts receivable and the projection of the number of months of supply on hand of an item of inventory based on past and forecast usage.
15. The auditor would evaluate whether the entity has an appropriate base for the principal assumptions used in the accounting estimate. In some cases, the assumptions will be based on industry or government statistics, such as future inflation rates, interest rates, employment rates and anticipated market growth. In other cases, the assumptions will be specific to the entity and will be based on internally generated data.
16. In evaluating the assumptions on which the estimate is based, the auditor would consider, among other things, whether they are:
 - Reasonable in light of actual results in prior periods.
 - Consistent with those used for other accounting estimates.
 - Consistent with management's plans which appear appropriate.

The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement.

17. In the case of complex estimating processes involving specialized techniques, it may be necessary for the auditor to use the work of an expert, for example, engineers for estimating quantities in stock piles of mineral ores. Guidance on how to use the work of an expert is provided in ISA 620 "Using the Work of an Expert."
18. The auditor would review the continuing appropriateness of formulae used by management in the preparation of accounting estimates. Such a review would reflect the auditor's knowledge of the financial results of the entity in prior periods, practices used by other entities in the industry and the future plans of management as disclosed to the auditor.

Testing of Calculations

19. The auditor would test the calculation procedures used by management. The nature, timing and extent of the auditor's testing will depend on such factors as the complexity involved in calculating the accounting estimate, the auditor's evaluation of the procedures and methods used by the entity in producing the estimate and the materiality of the estimate in the context of the financial statements.

Comparison of Previous Estimates with Actual Results

20. When possible, the auditor would compare accounting estimates made for prior periods with actual results of those periods to assist in:
 - (a) Obtaining evidence about the general reliability of the entity's estimating procedures;
 - (b) Considering whether adjustments to estimating formulae may be required; and
 - (c) Evaluating whether differences between actual results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

Consideration of Management's Approval Procedures

21. Material accounting estimates are ordinarily reviewed and approved by management. The auditor would consider whether such review and approval is performed by the appropriate level of management and that it is evidenced in the documentation supporting the determination of the accounting estimate.

Use of an Independent Estimate

22. The auditor may make or obtain an independent estimate and compare it with the accounting estimate prepared by management. When using an independent estimate the auditor would ordinarily evaluate the data, consider the assumptions and test the calculation procedures used in its development. It may also be appropriate to compare accounting estimates made for prior periods with actual results of those periods.

Review of Subsequent Events

23. Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management. The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and test the process used by management to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

Evaluation of Results of Audit Procedures

24. **The auditor should make a final assessment of the reasonableness of the estimate based on the auditor's knowledge of the business and whether the estimate is consistent with other audit evidence obtained during the audit.**
25. The auditor would consider whether there are any significant subsequent transactions or events which affect the data and the assumptions used in determining the accounting estimate.
26. Because of the uncertainties inherent in accounting estimates, evaluating differences can be more difficult than in other areas of the audit. When there is a difference between the auditor's estimate of the amount best supported by the available audit evidence and the estimated amount included in the financial statements, the auditor would determine whether such a difference requires adjustment. If the difference is reasonable, for example, because the amount in the financial statements falls within a range of acceptable results, it may not require adjustment. However, if the auditor believes the difference is unreasonable, management would be requested to revise the estimate. If management refuses to revise the estimate, the difference would be considered a misstatement and would be considered with all other misstatements in assessing whether the effect on the financial statements is material.
27. The auditor would also consider whether individual differences which have been accepted as reasonable are biased in one direction, so that, on a cumulative basis, they may have a material effect on the financial statements. In such circumstances, the auditor would evaluate the accounting estimates taken as a whole.

INTERNATIONAL STANDARD ON AUDITING 545

AUDITING FAIR VALUE MEASUREMENTS AND DISCLOSURES

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Appendix: Fair Value Measurements and Disclosures under Different Financial Reporting Frameworks	

International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA, not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the object of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, this ISA addresses audit considerations relating to the measurement, presentation and disclosure of material assets, liabilities and specific components of equity presented or disclosed at fair value in financial statements. Fair value measurements of assets, liabilities and components of equity may arise from both the initial recording of transactions and later changes in value. Changes in fair value measurements that occur over time may be treated in different ways under different financial reporting frameworks. For example, some financial reporting frameworks may require that such changes be reflected directly in equity, while others may require them to be reflected in income.
2. While this ISA provides guidance on auditing fair value measurements and disclosures, evidence obtained from other audit procedures also may provide evidence relevant to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant evidence about its valuation (such as the physical condition of an investment property).
3. **The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's identified financial reporting framework.**
4. Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation and ensure that the presentation and disclosure of the fair value measurements are in accordance with the entity's identified financial reporting framework.
5. Many measurements based on estimates, including fair value measurements, are inherently imprecise. In the case of fair value measurements, particularly those that do not involve contractual cash flows or for which market information is not available when making the estimate, fair value estimates often involve uncertainty in both the amount and timing of future cash flows. Fair value measurements also may be based on assumptions about future conditions, transactions or events whose outcome is uncertain and will therefore be subject to change over time. The auditor's consideration of such assumptions is based on information available to the auditor at the time of the audit and the auditor is not responsible for predicting future conditions, transactions or events which, had they been known at the time of the audit, may have had a significant effect on management's actions or management's assumptions underlying the fair value measurements and disclosures.

Assumptions used in fair value measurements are similar in nature to those required when developing other accounting estimates. ISA 540, “Audit of Accounting Estimates” provides guidance on auditing accounting estimates. This ISA, however, addresses considerations similar to those in ISA 540 as well as others in the specific context of fair value measurements and disclosures in accordance with an identified financial reporting framework.

6. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist. While this ISA provides guidance on auditing fair value measurements and disclosures, it does not address specific types of assets or liabilities, transactions, or industry-specific practices. The Appendix to this ISA discusses fair value measurements and disclosures under different financial reporting frameworks and the prevalence of fair value measurements, including the fact that different definitions of “fair value” may exist under such frameworks. For example, International Accounting Standard (IAS) 39, “Financial Instruments: Recognition and Measurement” defines fair value as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”
7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management’s plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.
8. The measurement of fair value may be relatively simple for certain assets or liabilities, for example, assets that are bought and sold in active and open markets that provide readily available and reliable information on the prices at which actual exchanges occur. The measurement of fair value for other assets or liabilities may be more complex. A specific asset may not have an active market or may possess characteristics that make it necessary for management to estimate its fair value (for example, an investment property or a complex derivative financial instrument). The estimation of fair value may be achieved through the use of a valuation model (for example, a model premised on

projections and discounting of future cash flows) or through the assistance of an expert, such as an independent valuer.

9. The uncertainty associated with an item, or the lack of objective data may make it incapable of reasonable estimation, in which case, the auditor considers whether the auditor's report needs modification to comply with ISA 700, "The Auditor's Report on Financial Statements."

Understanding the Entity's Process for Determining Fair Value Measurements and Disclosures and Relevant Control Procedures, and Assessing Risk

10. **The auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant control procedures sufficient to develop an effective audit approach.**
11. Management is responsible for establishing an accounting and financial reporting process for determining fair value measurements. In some cases, the measurement of fair value and therefore the process set up by management to determine fair value may be simple and reliable. For example, management may be able to refer to published price quotations to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgment need to be made as part of the measurement process. The auditor's understanding of the measurement process, including its complexity, helps determine the nature, timing and extent of the audit procedures.
12. When obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the auditor considers, for example:
 - The relevant control procedures over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between those committing the entity to the underlying transactions and those responsible for undertaking the valuations.
 - The expertise and experience of those persons determining the fair value measurements.
 - The role that information technology has in the process.
 - The types of accounts or transactions requiring fair value measurements or disclosures (for example, whether the accounts arise from the recording of routine and recurring transactions or whether they arise from non-routine or unusual transactions).
 - The extent to which the entity's process relies on a service organization to provide fair value measurements or the data that supports the measurement. When an entity uses a service organization, the auditor

complies with the requirements of ISA 402, “Audit Considerations Relating to Entities Using Service Organizations.”

- The extent to which the entity uses the work of experts in determining fair value measurements and disclosures (see paragraphs 29–32 of this Standard).
 - The significant management assumptions used in determining fair value.
 - The documentation supporting management’s assumptions.
 - The methods used to develop and apply management assumptions and to monitor changes in those assumptions.
 - The integrity of change controls and security procedures for valuation models and relevant information systems, including approval processes.
 - The controls over the consistency, timeliness and reliability of the data used in valuation models.
13. ISA 400, “Risk Assessments and Internal Control,” requires the auditor to obtain an understanding of the control procedures, sufficient to develop the audit plan. In the specific context of this standard, the auditor obtains such an understanding related to the determination of the entity’s fair value measurements and disclosures in order to plan the nature, timing and extent of the audit procedures.
14. **After obtaining an understanding of the entity’s process for determining fair value measurements and disclosures, the auditor should assess inherent and control risk related to the fair value measurements and disclosures in the financial statements to determine the nature, timing and extent of the audit procedures.**
15. The degree to which a fair value measurement is susceptible to misstatement is an inherent risk. Consequently, the nature, timing and extent of the audit procedures will depend upon the susceptibility to misstatement of a fair value measurement and whether the process for determining fair value measurements is relatively simple or complex.
16. ISA 400 discusses the inherent limitations of internal controls. As fair value determinations often involve subjective judgments by management, this may affect the nature of control procedures that are capable of being implemented. The susceptibility to misstatement of fair value measurements also may increase as the accounting and financial reporting requirements for fair value measurements become more complex. The auditor considers the inherent limitations of controls in such circumstances in assessing control risk.

Evaluating the Appropriateness of Fair Value Measurements and Disclosures

17. **The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in accordance with the entity’s financial reporting framework.**

18. The auditor's understanding of the requirements of the financial reporting framework and knowledge of the business and industry, together with the results of other audit procedures, are used to assess whether the accounting for assets or liabilities requiring fair value measurements is appropriate, and whether the disclosures about the fair value measurements and significant uncertainties related thereto are appropriate under the entity's financial reporting framework.
19. The evaluation of the appropriateness of the entity's fair value measurements under its financial reporting framework and the evaluation of audit evidence depends, in part, on the auditor's knowledge of the nature of the business. This is particularly true where the asset or liability or the valuation method is highly complex. For example, derivative financial instruments may be highly complex, with a risk that differing interpretations of how to determine fair values will result in different conclusions. The measurement of the fair value of some items, for example "in-process research and development" or intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations if such considerations are appropriate under the entity's financial reporting framework. Also, the auditor's knowledge of the business, together with the results of other audit procedures, may help identify assets for which management needs to recognize an impairment by using a fair value measurement pursuant to the entity's financial reporting framework.
20. Where the method for measuring fair value is specified by the financial reporting framework, for example, the requirement that the fair value of a marketable security be measured using quoted market prices as opposed to using a valuation model, the auditor considers whether the measurement of fair value is consistent with that method.
21. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. When management has determined that it has overcome the presumption that fair value can be reliably determined, the auditor obtains sufficient appropriate audit evidence to support such determination, and whether the item is properly accounted for under the financial reporting framework.
22. **The auditor should obtain evidence about management's intent to carry out specific courses of action, and consider its ability to do so, where relevant to the fair value measurements and disclosures under the entity's financial reporting framework.**
23. In some financial reporting frameworks, management's intentions with respect to an asset or liability are criteria for determining measurement, presentation, and disclosure requirements, and how changes in fair values are reported

within financial statements. In such financial reporting frameworks, management's intent is important in determining the appropriateness of the entity's use of fair value. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. While the extent of evidence to be obtained about management's intent is a matter of professional judgment, the auditor's procedures ordinarily include inquiries of management, with appropriate corroboration of responses, for example, by:

- Considering management's past history of carrying out its stated intentions with respect to assets or liabilities.
- Reviewing written plans and other documentation, including, where applicable, budgets, minutes, *etc.*
- Considering management's stated reasons for choosing a particular course of action.
- Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments.

The auditor also considers management's ability to pursue a specific course of action if ability is relevant to the use, or exemption from the use, of fair value measurement under the entity's financial reporting framework.

24. **Where alternative methods for measuring fair value are available under the entity's financial reporting framework, or where the method of measurement is not prescribed, the auditor should evaluate whether the method of measurement is appropriate in the circumstances under the entity's financial reporting framework.**
25. Evaluating whether the method of measurement of fair value is appropriate in the circumstances requires the use of professional judgment. When management selects one particular valuation method from alternative methods available under the entity's financial reporting framework, the auditor obtains an understanding of management's rationale for its selection by discussing with management its reasons for selecting the valuation method. The auditor considers whether:
 - (a) Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the financial reporting framework to support the selected method;
 - (b) The valuation method is appropriate in the circumstances given the nature of the asset or liability being valued and the entity's financial reporting framework; and
 - (c) The valuation method is appropriate in relation to the business, industry and environment in which the entity operates.

26. Management may have determined that different valuation methods result in a range of significantly different fair value measurements. In such cases, the auditor evaluates how the entity has investigated the reasons for these differences in establishing its fair value measurements.
27. **The auditor should evaluate whether the entity's method for its fair value measurements is applied consistently.**
28. Once management has selected a specific valuation method, the auditor evaluates whether the entity has consistently applied that basis in its fair value measurement, and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity, or changes in the requirements of the entity's financial reporting framework. If management has changed the valuation method, the auditor considers whether management can adequately demonstrate that the valuation method to which it has changed provides a more appropriate basis of measurement, or whether the change is supported by a change in the requirements of the entity's financial reporting framework or a change in circumstances. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

Using the Work of an Expert

29. **The auditor should determine the need to use the work of an expert.** The auditor may have the necessary skill and knowledge to plan and perform audit procedures related to fair values or may decide to use the work of an expert. In making such a determination, the auditor considers the matters discussed in paragraph 7 of ISA 620.
30. If the use of such an expert is planned, the auditor obtains sufficient appropriate audit evidence that such work is adequate for the purposes of the audit, and complies with the requirements of ISA 620.
31. When planning to use the work of an expert, the auditor considers whether the expert's understanding of the definition of fair value and the method that the expert will use to determine fair value are consistent with that of management and the requirements of the financial reporting framework. For example, the method used by an expert for estimating the fair value of real estate or a complex derivative, or the actuarial methodologies developed for making fair value estimates of insurance obligations, reinsurance receivables and similar items, may not be consistent with the measurement principles of the financial reporting framework. Accordingly, the auditor considers such matters, often by discussing, providing or reviewing instructions given to the expert or when reading the report of the expert.
32. In accordance with ISA 620, the auditor assesses the appropriateness of the expert's work as audit evidence. While the reasonableness of assumptions and the appropriateness of the methods used and their application are the

responsibility of the expert, the auditor obtains an understanding of the significant assumptions and methods used, and considers whether they are appropriate, complete and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures. The auditor often considers these matters by discussing them with the expert. Paragraphs 39 through 49 discuss the auditor's evaluation of significant assumptions used by management, including assumptions relied upon by management based on the work of an expert.

Testing the Entity's Fair Value Measurements and Disclosures

33. **Based on the assessment of inherent and control risk, the auditor should test the entity's fair value measurements and disclosures.**
34. Because of the wide range of possible fair value measurements, from relatively simple to complex, the auditor's planned audit procedures can vary significantly in nature, timing and extent. For example, substantive tests of the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data (see paragraphs 39–49), (b) developing independent fair value estimates to corroborate the appropriateness of the fair value measurement (see paragraph 52), or (c) considering the effect of subsequent events on the fair value measurement and disclosures (see paragraphs 53–55).
35. The existence of published price quotations in an active market ordinarily is the best evidence of fair value. Some fair value measurements, however, are inherently more complex than others. This complexity arises either because of the nature of the item being measured at fair value or because of the valuation method required by the financial reporting framework or selected by management. For example, in the absence of quoted prices in an active market, some financial reporting frameworks permit an estimate of fair value based on an alternative basis such as a discounted cash flow analysis or a comparative transaction model. Complex fair value measurements normally are characterized by greater uncertainty regarding the reliability of the measurement process. This greater uncertainty may be a result of:
 - Length of the forecast period.
 - The number of significant and complex assumptions associated with the process.
 - A higher degree of subjectivity associated with the assumptions and factors used in the process.
 - A higher degree of uncertainty associated with the future occurrence or outcome of events underlying the assumptions used.
 - Lack of objective data when highly subjective factors are used.
36. The auditor's understanding of the measurement process, including its complexity, helps guide the auditor's determination of detection risk and,

accordingly, the nature, timing and extent of audit procedures to be performed. The following are examples of considerations in the development of audit procedures:

- Using a price quotation to test valuation may require an understanding of the circumstances in which the quotation was developed. For example, where quoted securities are held for investment purposes, valuation at the listed market price may require adjustment under the entity's financial reporting framework if the holding is significantly large in size or is subject to restrictions in marketability.
- When using evidence provided by a third party, the auditor considers its reliability. For example, when information is obtained through the use of external confirmations, the auditor considers the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity in order to be satisfied with the reliability of the evidence. The extent of such procedures will vary according to the audit risk associated with the fair value measurements. The auditor complies with ISA 505, "External Confirmations" in this regard.
- Evidence supporting fair value measurements, for example, a valuation by an independent valuer, may be obtained at a date that does not coincide with the date at which the entity is required to measure and report that information in its financial statements. In such cases, the auditor obtains evidence that management has taken into account the effect of events, transactions and changes in circumstances occurring between the date of fair value measurement and the reporting date.
- Collateral often is assigned for certain types of investments in debt instruments that either are required to be measured at fair value or are evaluated for possible impairment. If the collateral is an important factor in measuring the fair value of the investment or evaluating its carrying amount, the auditor obtains sufficient appropriate audit evidence regarding the existence, value, rights and access to or transferability of such collateral, including consideration whether all appropriate liens have been filed, and considers whether appropriate disclosures about the collateral have been made under the entity's financial reporting framework.
- In some situations, additional procedures, such as the inspection of an asset by the auditor, may be necessary to obtain sufficient appropriate audit evidence about the appropriateness of a fair value measurement. For example, inspection of an investment property may be necessary to obtain information about the current physical condition of the asset relevant to its fair value, or inspection of a security may reveal a restriction on its marketability that may affect its value.

Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data

37. The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. A reliable process for determining fair value is one that results in reasonably consistent measurement and, where relevant, presentation and disclosure of fair value when used in similar circumstances. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:
 - (a) The assumptions used by management are reasonable;
 - (b) The fair value measurement was determined using an appropriate model, if applicable;
 - (c) Management used relevant information that was reasonably available at the time.
38. Estimation techniques and assumptions and the auditor's consideration and comparison of fair value measurements determined in prior periods, if any, to results obtained in the current period may provide evidence of the reliability of management's processes. However, the auditor also considers whether such variances result from changes in economic circumstances.
39. **Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair values, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.**
40. It is necessary for management to make assumptions, including assumptions relied upon by management based upon the work of an expert, to develop fair value measurements. For these purposes, management's assumptions also include those assumptions developed under the guidance of those charged with governance. Assumptions are integral components of more complex valuation methods, for example valuation methods that employ a combination of estimates of expected future cash flows together with estimates of the values of assets or liabilities in the future, discounted to the present. Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable. To provide a reasonable basis for the fair value measurements and disclosures, assumptions need to be relevant, reliable, neutral, understandable and complete. Paragraph 45 of ISA 100, "Assurance Engagements" describes these characteristics in more detail.
41. Specific assumptions will vary with the characteristics of the asset or liability being valued and the valuation method used (e.g., replacement cost, market or an income-based approach). For example, where discounted cash flows (an income-based approach) are used as the valuation method, there will be

assumptions about the level of cash flows, the period of time used in the analysis, and the discount rate.

42. Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor assesses the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical information and an evaluation of whether they are based on plans that are within the entity's capacity.
43. Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures is therefore not intended to obtain sufficient appropriate audit evidence to provide an opinion on the assumptions themselves. Rather, the auditor performs procedures to consider whether the assumptions provide a reasonable basis in measuring fair values in the context of an audit of the financial statements taken as a whole.
44. Identifying those assumptions that appear to be significant to the fair value measurement requires the exercise of judgment by management. The auditor focuses attention on significant assumptions. Generally, significant assumptions cover matters that materially affect the fair value measurement and may include those that are:
 - (a) Sensitive to variation or uncertainty in amount or nature. For example, assumptions about short-term interest rates may be less susceptible to significant variation compared to assumptions about long-term interest rates;
 - (b) Susceptible to misapplication or bias.
45. The auditor considers the sensitivity of the valuation to changes in significant assumptions, including market conditions that may affect the value. Where applicable, the auditor encourages management to use such techniques as sensitivity analysis to help identify particularly sensitive assumptions. In the absence of such management analysis, the auditor considers whether to employ such techniques. The auditor also considers whether the uncertainty associated with a fair value measurement, or the lack of objective data may make it incapable of reasonable estimation under the entity's financial reporting framework (see paragraph 9).
46. The consideration of whether the assumptions provide a reasonable basis for the fair value measurements relates to the whole set of assumptions as well as to each assumption individually. Assumptions are frequently interdependent, and therefore, need to be internally consistent. A particular assumption that may appear reasonable when taken in isolation may not be reasonable when used in conjunction with other assumptions. The auditor considers whether management has identified the significant assumptions and factors influencing the measurement of fair value.

47. The assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows) ordinarily will reflect what management expects will be the outcome of specific objectives and strategies. To be reasonable, such assumptions, individually and taken as a whole, also need to be realistic and consistent with:
- (a) The general economic environment and the entity's economic circumstances;
 - (b) The plans of the entity;
 - (c) Assumptions made in prior periods, if appropriate
 - (d) Past experience of, or previous conditions experienced by, the entity to the extent currently applicable;
 - (e) Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and
 - (f) If applicable, the risk associated with cash flows, including the potential variability of the cash flows and the related effect on the discounted rate.

Where assumptions are reflective of management's intent and ability to carry out specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience (see paragraphs 22 and 23).

48. If management relies on historical financial information in the development of assumptions, the auditor considers the extent to which such reliance is justified. However, historical information might not be representative of future conditions or events, for example, if management intends to engage in new activities or circumstances change.
49. For items valued by the entity using a valuation model, the auditor is not expected to substitute his or her judgment for that of the entity's management. Rather, the auditor reviews the model, and evaluates whether the model is appropriate and the assumptions used are reasonable. For example, it may be inappropriate to use a discounted cash flow method in valuing an equity investment in a start-up enterprise if there are no current revenues on which to base the forecast of future earnings or cash flows.
50. **The auditor should test the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions.**
51. The auditor evaluates whether the data on which the fair value measurements are based, including the data used in the work of an expert, are accurate, complete and relevant; and whether the fair value measurements have been properly determined using such data and management's assumptions. The auditor's tests also may include, for example, procedures such as verifying the

source of the data, mathematical re-computation and reviewing of information for internal consistency, including whether such information is consistent with management's intent to carry out specific courses of action discussed in paragraphs 22 and 23.

Developing Independent Fair Value Estimates for Corroborative Purposes

52. The auditor may make an independent estimate of fair value (for example, by using an auditor-developed model) to corroborate the entity's fair value measurement. When developing an independent estimate using management's assumptions, the auditor evaluates those assumptions as discussed in paragraphs 39 to 49. Instead of using management's assumptions the auditor may develop separate assumptions to make a comparison with management's fair value measurements. In that situation, the auditor nevertheless understands management's assumptions. The auditor uses that understanding to determine that the auditor's model considers the significant variables and to evaluate any significant difference from management's estimate. The auditor also tests the data used to develop the fair value measurements and disclosures as discussed in paragraphs 50 and 51. The auditor considers the guidance contained in ISA 520, "Analytical Procedures" when performing these procedures during an audit.

Subsequent Events

53. **The auditor should consider the effect of subsequent events on the fair value measurements and disclosures in the financial statements.**
54. Transactions and events that occur after period-end but prior to completion of the audit, may provide appropriate audit evidence regarding the fair value measurements made by management. For example, a sale of investment property shortly after the period-end may provide audit evidence relating to the fair value measurement.
55. In the period after a financial statement period-end, however, circumstances may change from those existing at the period-end. Fair value information after the period -end may reflect events occurring after the period-end and not the circumstances existing at the balance sheet date. For example, the prices of actively traded marketable securities that change after the period-end ordinarily do not constitute appropriate audit evidence of the values of the securities that existed at the period-end. The auditor complies with ISA 560, "Subsequent Events" when evaluating audit evidence relating to such events.

Disclosures About Fair Values

56. **The auditor should evaluate whether the disclosures about fair values made by the entity are in accordance with its financial reporting framework.**

57. Disclosure of fair value information is an important aspect of financial statements in many financial reporting frameworks. Often, fair value disclosure is required because of the relevance to users in the evaluation of an entity's performance and financial position. In addition to the fair value information required by the financial reporting framework, some entities disclose voluntary additional fair value information in the notes to the financial statements.
58. When auditing fair value measurements and related disclosures included in the notes to the financial statements, whether required by the financial reporting framework or disclosed voluntarily, the auditor ordinarily performs essentially the same types of audit procedures as those employed in auditing a fair value measurement recognized in the financial statements. The auditor obtains sufficient appropriate audit evidence that the valuation principles are appropriate under the entity's financial reporting framework, are being consistently applied, and the method of estimation and significant assumptions used are properly disclosed in accordance with the entity's financial reporting framework. The auditor also considers whether voluntary information may be inappropriate in the context of the financial statements. For example, management may disclose a current sales value for an asset without mentioning that significant restrictions under contractual arrangements preclude the sale in the immediate future.
59. The auditor evaluates whether the entity has made appropriate disclosures about fair value information as called for by its financial reporting framework. If an item contains a high degree of measurement uncertainty, the auditor assesses whether the disclosures are sufficient to inform users of such uncertainty. For example, the auditor might evaluate whether disclosures about a range of amounts, and the assumptions used in determining the range, within which the fair value is reasonably believed to lie is appropriate under the entity's financial reporting framework, when management considers a single amount presentation not appropriate. Where applicable, the auditor also considers whether the entity has complied with the accounting and disclosure requirements relating to changes in the valuation method used to determine fair value measurements.
60. When disclosure of fair value information under the applicable financial reporting framework is omitted because it is not practicable to determine fair value with sufficient reliability, the auditor evaluates the adequacy of disclosures required in these circumstances. If the entity has not appropriately disclosed fair value information required by the financial reporting framework, the auditor evaluates whether the financial statements are materially misstated by the departure from the financial reporting framework.

Evaluating the Results of Audit Procedures

61. **In making a final assessment of whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's**

financial reporting framework, the auditor should evaluate the sufficiency and appropriateness of the audit evidence obtained as well as the consistency of that evidence with other evidence obtained and evaluated during the audit.

62. When assessing whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's financial reporting framework, the auditor evaluates the consistency of the information and audit evidence obtained during the audit of fair value measurements with other audit evidence obtained during the audit, in the context of the financial statements taken as a whole. For example, the auditor considers whether there is or should be a relationship or correlation between the interest rates used to discount estimated future cash flows in determining the fair value of an investment property and interest rates on borrowings currently being incurred by the entity to acquire investment property.

Management Representations

63. **The auditor should obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures.**
64. ISA 580, "Management Representations" discusses the use of management representations as audit evidence. Depending on the nature, materiality and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about:
 - The appropriateness of the measurement methods, including related assumptions, used by management in determining fair values within the applicable financial reporting framework, and the consistency in application of the methods.
 - The basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's financial reporting framework.
 - The completeness and appropriateness of disclosures related to fair values under the entity's financial reporting framework.
 - Whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements.

Communication with Those Charged with Governance

65. ISA 260, "Communication of Audit Matters with Those Charged with Governance" requires auditors to communicate audit matters of governance interest with those charged with governance. Because of the uncertainties often

involved with some fair value measurements, the potential effect on the financial statements of any significant risks may be of governance interest. For example, the auditor considers communicating the nature of significant assumptions used in fair value measurements, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the items being measured at fair value to the financial statements as a whole. The auditor considers the guidance contained in ISA 260 when determining the nature and form of communication.

Effective Date

66. This ISA is effective for audits of financial statements for periods ending on or after December 31, 2003. Earlier application of the provisions of this ISA is permissible.

Public Sector Perspective

1. *Many governments are moving to accrual accounting and are adopting fair value as the basis of valuation for many classes of the assets and liabilities that they hold, or for disclosures of items in the financial statements. The broad principles of this ISA are therefore applicable to the consideration of the audit of fair value measurements and disclosures included in the financial statements of public sector entities.*
2. *Paragraph 3 of the ISA states that when fair value measurements and disclosures are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence that such measurements and disclosures are in accordance with the entity's identified financial reporting framework. The International Public Sector Accounting Standards accounting framework include a number of standards that require or allow the recognition or disclosure of fair values.*
3. *As noted in paragraph 8 of the ISA, determining the fair value of certain assets or liabilities may be complex where there is no active market. This can be a particular issue in the Public Sector, where entities have significant holdings of specialized assets. Furthermore many assets held by public sector entities do not generate cash flows. In these circumstances a fair value or similar current value may be estimated by reference to other valuation methods including, but not limited to, depreciated replacement cost and indexed price method.*

Appendix

Fair Value Measurements and Disclosures under Different Financial Reporting Frameworks

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.
2. Different definitions of fair value may exist among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, International Accounting Standard (IAS) 39, “Financial Instruments: Recognition and Measurement” defines fair value as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”. The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as “entity-specific value”, “value in use”, or similar terms, but may still fall within the concept of fair value in this ISA.
3. Different financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management’s intent to carry out certain courses of action with respect to the specific asset or liability.
4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:
 - Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information.
 - Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met.

- Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows.
 - Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework).
 - Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.
5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable.
 6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property's condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications.

Prevalence of Fair Value Measurements

7. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of:
 - Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically “marked-to-market”.
 - Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.

- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity's or unit's group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.
- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity's financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Transactions involving the exchange of assets between independent parties without monetary consideration. For example, a non-monetary exchange of plant facilities in different lines of business.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognized in the financial statements.

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RELATED PARTIES

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties regardless of whether International Accounting Standard (IAS) 24, "Related Party Disclosures," or similar requirement, is part of the financial reporting framework.
2. **The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related party transactions that are material to the financial statements.** However, an audit cannot be expected to detect all related party transactions.
3. As indicated in ISA 200 "Objective and General Principles Governing an Audit of Financial Statements," in certain circumstances there are limitations that may affect the persuasiveness of evidence available to draw conclusions on particular financial statement assertions. Because of the degree of uncertainty associated with the financial statement assertions regarding the completeness of related parties, the procedures identified in this ISA will provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstance identified by the auditor that:
 - (a) Increases the risk of misstatement beyond that which would ordinarily be expected; or
 - (b) Indicates that a material misstatement regarding related parties has occurred.

Where there is any indication that such circumstances exist, the auditor should perform modified, extended or additional procedures as are appropriate in the circumstances.

4. Definitions regarding related parties are given in IAS 24 and are adopted for the purposes of this ISA.¹
5. Management is responsible for the identification and disclosure of related parties and transactions with such parties. This responsibility requires management to implement adequate accounting and internal control systems to ensure that transactions with related parties are appropriately identified in the accounting records and disclosed in the financial statements.
6. The auditor needs to have a level of knowledge of the entity's business and industry that will enable identification of the events, transactions and practices

¹ Definitions of related party and related party transactions from IAS 24, "Related Party Disclosures," are:

Related party—parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions.

Related party transactions—a transfer of resources or obligations between related parties, regardless of whether a price is charged.

that may have a material effect on the financial statements. While the existence of related parties and transactions between such parties are considered ordinary features of business, the auditor needs to be aware of them because:

- (a) The financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as those required by IAS 24;
- (b) The existence of related parties or related party transactions may affect the financial statements. For example, the entity's tax liability and expense may be affected by the tax laws in various jurisdictions which require special consideration when related parties exist;
- (c) The source of audit evidence affects the auditor's assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties; and
- (d) A related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud.

Existence and Disclosure of Related Parties

7. **The auditor should review information provided by the directors and management identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:**
 - (a) **Review prior year working papers for names of known related parties;**
 - (b) **Review the entity's procedures for identification of related parties;**
 - (c) **Inquire as to the affiliation of directors and officers with other entities;**
 - (d) **Review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;**
 - (e) **Review minutes of the meetings of shareholders and the board of directors and other relevant statutory records such as the register of directors' interests;**
 - (f) **Inquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties; and**
 - (g) **Review the entity's income tax returns and other information supplied to regulatory agencies.**

If, in the auditor's judgment, the risk of significant related parties remaining undetected is low, these procedures may be modified as appropriate.

8. **Where the financial reporting framework requires disclosure of related party relationships, the auditor should be satisfied that the disclosure is adequate.**

Transactions with Related Parties

9. **The auditor should review information provided by directors and management identifying related party transactions and should be alert for other material related party transactions.**
10. **When obtaining an understanding of the accounting and internal control systems and making a preliminary assessment of control risk, the auditor should consider the adequacy of control procedures over the authorization and recording of related party transactions.**
11. During the course of the audit, the auditor needs to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include:
 - Transactions which have abnormal terms of trade, such as unusual prices, interest rates, guarantees, and repayment terms.
 - Transactions which lack an apparent logical business reason for their occurrence.
 - Transactions in which substance differs from form.
 - Transactions processed in an unusual manner.
 - High volume or significant transactions with certain customers or suppliers as compared with others.
 - Unrecorded transactions such as the receipt or provision of management services at no charge.
12. During the course of the audit, the auditor carries out procedures which may identify the existence of transactions with related parties. Examples include:
 - Performing detailed tests of transactions and balances.
 - Reviewing minutes of meetings of shareholders and directors.
 - Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
 - Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.

- Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity.

Examining Identified Related Party Transactions

13. **In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed.**
14. Given the nature of related party relationships, evidence of a related party transaction may be limited, for example, regarding the existence of inventory held by a related party on consignment or an instruction from a parent company to a subsidiary to record a royalty expense. Because of the limited availability of appropriate evidence about such transactions, the auditor would consider performing procedures such as:
 - Confirming the terms and amount of the transaction with the related party.
 - Inspecting evidence in possession of the related party.
 - Confirming or discussing information with persons associated with the transaction, such as banks, lawyers, guarantors and agents.

Management Representations

15. **The auditor should obtain a written representation from management concerning:**
 - (a) **The completeness of information provided regarding the identification of related parties; and**
 - (b) **The adequacy of related party disclosures in the financial statements.**

Audit Conclusions and Reporting

16. **If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should modify the audit report appropriately.**

Public Sector Perspective

1. *In applying the audit principles in this ISA, auditors have to make reference to legislative requirements which are applicable to public sector entities and employees in respect of related party transactions. Such legislation may prohibit entities and employees from entering into transactions with related parties. There may also be a requirement for public sector employees to declare their interests in entities with which they transact on a professional and/or commercial basis. Where such legislative requirements exist, the audit procedures would need to be expanded to detect instances of noncompliance with these requirements.*

2. *While International Public Sector Guideline 1, “Financial Reporting by Government Business Enterprises,” indicates that all International Accounting Standards (IASs) apply to business enterprises in the public sector, IAS 24, Related Party Disclosures does not require that transactions between state controlled enterprises be disclosed. Definitions of related parties included in IAS 24 and this ISA do not address all circumstances relevant to public sector entities. For example, the status, for purposes of application of this ISA, of the relationship between ministers and departments of state, and departments of state and statutory authorities or government agencies is not discussed.*

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SUBSEQUENT EVENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility regarding subsequent events. In this ISA, the term "subsequent events" is used to refer to both events occurring between period end and the date of the auditor's report, and facts discovered after the date of the auditor's report.
2. **The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.**
3. International Accounting Standard 10, "Contingencies and Events Occurring After the Balance Sheet Date," deals with the treatment in financial statements of events, both favorable and unfavorable, occurring after period end and identifies two types of events:
 - (a) Those that provide further evidence of conditions that existed at period end; and
 - (b) Those that are indicative of conditions that arose subsequent to period end.

Events Occurring up to the Date of the Auditor's Report

4. **The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.** These procedures are in addition to routine procedures which may be applied to specific transactions occurring after period end to obtain audit evidence as to account balances as at period end, for example, the testing of inventory cutoff and payments to creditors. The auditor is not, however, expected to conduct a continuing review of all matters to which previously applied procedures have provided satisfactory conclusions.
5. The procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report and ordinarily include the following:
 - Reviewing procedures management has established to ensure that subsequent events are identified.
 - Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after period end and inquiring about matters discussed at meetings for which minutes are not yet available.
 - Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.

- Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.
 - Inquiring of management as to whether any subsequent events have occurred which might affect the financial statements. Examples of inquiries of management on specific matters are:
 - The current status of items that were accounted for on the basis of preliminary or inconclusive data.
 - Whether new commitments, borrowings or guarantees have been entered into.
 - Whether sales of assets have occurred or are planned.
 - Whether the issue of new shares or debentures or an agreement to merge or liquidate has been made or is planned.
 - Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
 - Whether there have been any developments regarding risk areas and contingencies.
 - Whether any unusual accounting adjustments have been made or are contemplated.
 - Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
6. When a component, such as a division, branch or subsidiary, is audited by another auditor, the auditor would consider the other auditor's procedures regarding events after period end and the need to inform the other auditor of the planned date of the auditor's report.
 7. **When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for and adequately disclosed in the financial statements.**

Facts Discovered After the Date of the Auditor's Report but Before the Financial Statements are Issued

8. The auditor does not have any responsibility to perform procedures or make any inquiry regarding the financial statements after the date of the auditor's report. During the period from the date of the auditor's report to the date the financial statements are issued, the responsibility to inform the auditor of facts which may affect the financial statements rests with management.

9. **When, after the date of the auditor's report but before the financial statements are issued, the auditor becomes aware of a fact which may materially affect the financial statements, the auditor should consider whether the financial statements need amendment, should discuss the matter with management, and should take the action appropriate in the circumstances.**
10. When management amends the financial statements, the auditor would carry out the procedures necessary in the circumstances and would provide management with a new report on the amended financial statements. The new auditor's report would be dated not earlier than the date the amended financial statements are signed or approved and, accordingly, the procedures referred to in paragraphs 4 and 5 would be extended to the date of the new auditor's report.
11. **When management does not amend the financial statements in circumstances where the auditor believes they need to be amended and the auditor's report has not been released to the entity, the auditor should express a qualified opinion or an adverse opinion.**
12. When the auditor's report has been released to the entity, the auditor would notify those persons ultimately responsible for the overall direction of the entity not to issue financial statements and the auditor's report thereon to third parties. If the financial statements are subsequently released, the auditor needs to take action to prevent reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyer.

Facts Discovered After the Financial Statements Have Been Issued

13. After the financial statements have been issued, the auditor has no obligation to make any inquiry regarding such financial statements.
14. **When, after the financial statements have been issued, the auditor becomes aware of a fact which existed at the date of the auditor's report and which, if known at that date, may have caused the auditor to modify the auditor's report, the auditor should consider whether the financial statements need revision, should discuss the matter with management, and should take the action appropriate in the circumstances.**
15. When management revises the financial statements, the auditor would carry out the audit procedures necessary in the circumstances, would review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation, and would issue a new report on the revised financial statements.
16. **The new auditor's report should include an emphasis of a matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued**

financial statements and to the earlier report issued by the auditor. The new auditor's report would be dated not earlier than the date the revised financial statements are approved and, accordingly, the procedures referred to in paragraphs 4 and 5 would ordinarily be extended to the date of the new auditor's report. Local regulations of some countries permit the auditor to restrict the audit procedures regarding the revised financial statements to the effects of the subsequent event that necessitated the revision. In such cases, the new auditor's report would contain a statement to that effect.

17. When management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation and does not revise the financial statements in circumstances where the auditor believes they need to be revised, the auditor would notify those persons ultimately responsible for the overall direction of the entity that action will be taken by the auditor to prevent future reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyers.
18. It may not be necessary to revise the financial statements and issue a new auditor's report when issue of the financial statements for the following period is imminent, provided appropriate disclosures are to be made in such statements.

Offering of Securities to the Public

19. **In cases involving the offering of securities to the public, the auditor should consider any legal and related requirements applicable to the auditor in all jurisdictions in which the securities are being offered.** For example, the auditor may be required to carry out additional audit procedures to the date of the final offering document. These procedures would ordinarily include carrying out the procedures referred to in paragraphs 4 and 5 up to a date at or near the effective date of the final offering document and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.

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GOING CONCERN

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

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The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility in the audit of financial statements with respect to the going concern assumption used in the preparation of the financial statements, including considering management's assessment of the entity's ability to continue as a going concern.
2. **When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements.**

Management's Responsibility

3. The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.
4. Some financial reporting frameworks contain an explicit requirement¹ for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. For example, International Accounting Standard 1 (revised 1997), "Presentation of Financial Statements," requires management to make an assessment of an enterprise's ability to continue as a going concern.²

¹ The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may be set out in accounting standards, legislation or regulation.

² IAS 1, "Presentation of Financial Statements," paragraphs 23 and 24 state: "When preparing financial statements, management should make an assessment of an enterprise's ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise's ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reasons why the enterprise is not considered to be a going concern."

In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an enterprise has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate can be reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate."

5. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of the financial statements, management has a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit responsibility to do so.
6. When there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis.
7. Management's assessment of the going concern assumption involves making a judgment, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. The following factors are relevant:
 - In general terms, the degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future a judgment is being made about the outcome of an event or condition. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
 - Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events can contradict a judgment which was reasonable at the time it was made.
 - The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors all affect the judgment regarding the outcome of events or conditions.
8. Examples of events or conditions, which individually or collectively, may cast significant doubt about the going concern assumption are set out below. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty³ exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by debtors and other creditors.

³ The phrase "material uncertainty" is used in IAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the enterprise's ability to continue as a going concern that should be disclosed in the financial statements. In other financial reporting frameworks, and elsewhere in the ISA's, the phrase "significant uncertainties" is used in similar circumstances.

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- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labor difficulties or shortages of important supplies.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Auditor's Responsibility

9. The auditor's responsibility is to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements. The auditor considers the appropriateness of management's use of the going concern assumption even if the financial reporting framework used in the preparation of the financial statements does

not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

10. The auditor cannot predict future events or conditions that may cause an entity to cease to continue as a going concern. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Planning Considerations

11. **In planning the audit, the auditor should consider whether there are events or conditions which may cast significant doubt on the entity's ability to continue as a going concern.**
12. **The auditor should remain alert for evidence of events or conditions which may cast significant doubt on the entity's ability to continue as a going concern throughout the audit. If such events or conditions are identified, the auditor should, in addition to performing the procedures in paragraph 26, consider whether they affect the auditor's assessments of the components of audit risk.**
13. The auditor considers events and conditions relating to the going concern assumption during the planning process, because this consideration allows for more timely discussions with management, review of management's plans and resolution of any identified going concern issues.
14. In some cases, management may have already made a preliminary assessment at the early stages of the audit. If so, the auditor reviews that assessment to determine whether management has identified events or conditions, such as those discussed in paragraph 8, and management's plans to address them.
15. If management has not yet made a preliminary assessment, the auditor discusses with management the basis for their intended use of the going concern assumption, and inquires of management whether events or conditions, such as those discussed in paragraph 8, exist. The auditor may request management to begin making its assessment, particularly when the auditor has already identified events or conditions relating to the going concern assumption.
16. The auditor considers the effect of identified events or conditions when making preliminary assessments of the components of audit risk and, therefore, their existence may affect the nature, timing and extent of the auditor's procedures.

Evaluating Management's Assessment

17. **The auditor should evaluate management's assessment of the entity's ability to continue as a going concern.**
18. **The auditor should consider the same period as that used by management in making its assessment under the financial reporting framework. If**

management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the balance sheet date, the auditor should ask management to extend its assessment period to twelve months from the balance sheet date.

19. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of the going concern assumption. As noted in paragraph 7, most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information.⁴
20. In evaluating management's assessment, the auditor considers the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action. The auditor considers whether the assessment has taken into account all relevant information of which the auditor is aware as a result of the audit procedures.
21. As noted in paragraph 6, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In such circumstances, the auditor's conclusion about the appropriateness of this assessment normally is also made without the need for performing detailed procedures. When events or conditions have been identified which may cast significant doubt about the entity's ability to continue as a going concern, however, the auditor performs additional audit procedures, as described in paragraph 26.

Period Beyond Management's Assessment

22. **The auditor should inquire of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the entity's ability to continue as a going concern.**
23. The auditor is alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern assumption in preparing the financial statements. The auditor may become aware of such known events or conditions during the planning and conduct of the audit, including subsequent events procedures.
24. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is further into the future, in considering such events or conditions, the indications of going concern issues will need to be significant before the auditor considers taking further action.

⁴ For example, IAS 1 defines this as a period that should be at least, but is not limited to, twelve months from the balance sheet date.

The auditor may need to ask management to determine the potential significance of the event or condition on their going concern assessment.

25. The auditor does not have a responsibility to design procedures other than inquiry of management to test for indications of events or conditions which cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management which, as discussed in paragraph 18, would be at least twelve months from the balance sheet date.

Additional Audit Procedures When Events or Conditions are Identified

26. **When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:**
 - (a) **Review management's plans for future actions based on its going concern assessment;**
 - (b) **Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out procedures considered necessary, including considering the effect of any plans of management and other mitigating factors; and**
 - (c) **Seek written representations from management regarding its plans for future action.**
27. Events or conditions which may cast significant doubt on the entity's ability to continue as a going concern may be identified during the planning of the engagement or in the course of performing audit procedures. The process of considering events or conditions continues as the audit progresses. When the auditor believes such events or conditions may cast significant doubt on the entity's ability to continue as a going concern, certain procedures may take on added significance. The auditor inquires of management as to its plans for future action, including its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. The auditor also considers whether any additional facts or information are available since the date on which management made its assessment. The auditor obtains sufficient appropriate audit evidence that management's plans are feasible and that the outcome of these plans will improve the situation.
28. Procedures that are relevant in this regard may include:
 - Analyzing and discussing cash flow, profit and other relevant forecasts with management.
 - Analyzing and discussing the entity's latest available interim financial statements.
 - Reviewing the terms of debentures and loan agreements and determining whether any have been breached.

- Reading minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
 - Inquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
 - Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
 - Considering the entity's plans to deal with unfilled customer orders.
 - Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
29. When analysis of cash flow is a significant factor in considering the future outcome of events or conditions the auditor considers:
- (a) The reliability of the entity's system for generating such information; and
 - (b) Whether there is adequate support for the assumptions underlying the forecast.
- In addition the auditor compares:
- (c) The prospective financial information for recent prior periods with historical results; and
 - (d) The prospective financial information for the current period with results achieved to date.

Audit Conclusions and Reporting

30. **Based on the audit evidence obtained, the auditor should determine if, in the auditor's judgment, a material uncertainty exists related to events or conditions that alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern.**
31. A material uncertainty exists when the magnitude of its potential impact is such that, in the auditor's judgment, clear disclosure of the nature and implications of the uncertainty is necessary for the presentation of the financial statements not to be misleading.

Going Concern Assumption Appropriate but a Material Uncertainty Exists

32. If the use of the going concern assumption is appropriate but a material uncertainty exists, the auditor considers whether the financial statements:
- (a) Adequately describe the principal events or conditions that give rise to the significant doubt on the entity's ability to continue in operation and management's plans to deal with these events or conditions; and

- (b) State clearly that there is a material uncertainty related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

33. **If adequate disclosure is made in the financial statements, the auditor should express an unqualified opinion but modify the auditor's report by adding an emphasis of matter paragraph that highlights the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and draws attention to the note in the financial statements that discloses the matters set out in paragraph 32.** In assessing the adequacy of the financial statement disclosure, the auditor considers whether the information explicitly draws the reader's attention to the possibility that the entity may be unable to continue realizing its assets and discharging its liabilities in the normal course of business. The following is an example of such a paragraph when the auditor is satisfied as to the adequacy of the note disclosure:

“Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by ZZZ. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern.”

In extreme cases, such as situations involving multiple material uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

34. **If adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate (ISA 700, “The Auditor's Report on Financial Statements,” paragraphs 45–46). The report should include specific reference to the fact that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.** The following is an example of the relevant paragraphs when a qualified opinion is to be expressed:

“The Company's financing arrangements expire and amounts outstanding are payable on March 19, 20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty which may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and fair view of (present fairly, in all material respects,) the financial position of the Company at December 31, 20X0 and the results of its operations and its cash flows for the year then ended in accordance with ...”

The following is an example of the relevant paragraphs when an adverse opinion is to be expressed:

“The Company’s financing arrangements expired and the amount outstanding was payable on December 31, 20X0. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty which may cast significant doubt on the Company’s ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

In our opinion, because of the omission of the information mentioned in the preceding paragraph, the financial statements do not give a true and fair view of (or do not present fairly) the financial position of the Company as at December 31, 20X0, and of its results of operations and its cash flows for the year then ended in accordance with....(and do not comply with....)”

Going Concern Assumption Inappropriate

35. **If, in the auditor’s judgment, the entity will not be able to continue as a going concern, the auditor should express an adverse opinion if the financial statements have been prepared on a going concern basis.** If, on the basis of the additional procedures carried out and the information obtained, including the effect of management’s plans, the auditor’s judgment is that the entity will not be able to continue as a going concern, the auditor concludes, regardless of whether or not disclosure has been made, that the going concern assumption used in the preparation of the financial statements is inappropriate and expresses an adverse opinion.
36. When the entity’s management has concluded that the going concern assumption used in the preparation of the financial statements is not appropriate, the financial statements need to be prepared on an alternative authoritative basis. If on the basis of the additional procedures carried out and the information obtained the auditor determines the alternative basis is appropriate, the auditor can issue an unqualified opinion if there is adequate disclosure but may require an emphasis of matter in the auditor’s report to draw the user’s attention to that basis.

Management Unwilling to Make or Extend its Assessment

37. **If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor should consider the need to modify the auditor's report as a result of the limitation on the scope of the auditor's work.** In certain circumstances, such as those described in paragraphs 15, 18 and 24, the auditor may believe that it is necessary to ask management to make or extend its assessment. If management is unwilling to do so, it is not the auditor's responsibility to rectify the lack of analysis by management, and a modified report may be appropriate because it may not be possible for the auditor to obtain sufficient appropriate evidence regarding the use of the going concern assumption in the preparation of the financial statements.
38. In some circumstances, the lack of analysis by management may not preclude the auditor from being satisfied about the entity's ability to continue as a going concern. For example, the auditor's other procedures may be sufficient to assess the appropriateness of management's use of the going concern assumption in the preparation of the financial statements because the entity has a history of profitable operations and a ready access to financial resources. In other circumstances, however, the auditor may not be able to confirm or dispel, in the absence of management's assessment, whether or not events or conditions exist which indicate there may be a significant doubt on the entity's ability to continue as a going concern, or the existence of plans management has put in place to address them or other mitigating factors. In these circumstances, the auditor modifies the auditor's report as discussed in ISA 700, "The Auditor's Report on Financial Statements," paragraphs 36–44.

Significant Delay in the Signature or Approval of Financial Statements

39. When there is significant delay in the signature or approval of the financial statements by management after the balance sheet date, the auditor considers the reasons for the delay. When the delay could be related to events or conditions relating to the going concern assessment, the auditor considers the need to perform additional audit procedures, as described in paragraph 26, as well as the effect on the auditor's conclusion regarding the existence of a material uncertainty, as described in paragraph 30.

Effective Date

40. This ISA is effective for audits of financial statements for periods ending on or after December 31, 2000.

Public Sector Perspective

1. *The appropriateness of the use of the going concern assumption in the preparation of the financial statements is generally not in question when auditing either a central government or those public sector entities having*

GOING CONCERN

funding arrangements backed by a central government. However, where such arrangements do not exist, or where central government funding of the entity may be withdrawn and the existence of the entity may be at risk, this ISA will provide useful guidance. As governments corporatize and privatize government entities, going concern issues will become increasingly relevant to the public sector.

INTERNATIONAL STANDARD ON AUDITING 580

MANAGEMENT REPRESENTATIONS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.
2. **The auditor should obtain appropriate representations from management.**

Acknowledgment by Management of its Responsibility for the Financial Statements

3. **The auditor should obtain evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the relevant financial reporting framework, and has approved the financial statements.** The auditor can obtain evidence of management's acknowledgment of such responsibility and approval from relevant minutes of meetings of the board of directors or similar body or by obtaining a written representation from management or a signed copy of the financial statements.

Representations by Management as Audit Evidence

4. **The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.** The possibility of misunderstandings between the auditor and management is reduced when oral representations are confirmed by management in writing. Matters which might be included in a letter from management or in a confirmatory letter to management are contained in the example of a management representation letter in the Appendix to this ISA.
5. Written representations requested from management may be limited to matters that are considered either individually or collectively material to the financial statements. Regarding certain items it may be necessary to inform management of the auditor's understanding of materiality.
6. During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific inquiries. When such representations relate to matters which are material to the financial statements, the auditor will need to:
 - (a) Seek corroborative audit evidence from sources inside or outside the entity;
 - (b) Evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and

- (c) Consider whether the individuals making the representations can be expected to be well informed on the particular matters.
- 7. Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain. If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter which has, or may have, a material effect on the financial statements and such evidence is expected to be available, this will constitute a limitation in the scope of the audit, even if a representation from management has been received on the matter.
- 8. In certain instances, a representation by management may be the only audit evidence which can reasonably be expected to be available. For example, the auditor would not necessarily expect that other audit evidence would be available to corroborate management's intention to hold a specific investment for long-term appreciation.
- 9. **If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.**

Documentation of Representations by Management

- 10. The auditor would ordinarily include in audit working papers evidence of management's representations in the form of a summary of oral discussions with management or written representations from management.
- 11. A written representation is better audit evidence than an oral representation and can take the form of:
 - (a) A representation letter from management;
 - (b) A letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or
 - (c) Relevant minutes of meetings of the board of directors or similar body or a signed copy of the financial statements.

Basic Elements of a Management Representation Letter

- 12. When requesting a management representation letter, the auditor would request that it be addressed to the auditor, contain specified information and be appropriately dated and signed.
- 13. A management representation letter would ordinarily be dated the same date as the auditor's report. However, in certain circumstances, a separate representation letter regarding specific transactions or other events may also be

obtained during the course of the audit or at a date after the date of the auditor's report, for example, on the date of a public offering.

14. A management representation letter would ordinarily be signed by the members of management who have primary responsibility for the entity and its financial aspects (ordinarily the senior executive officer and the senior financial officer) based on the best of their knowledge and belief. In certain circumstances, the auditor may wish to obtain representation letters from other members of management. For example, the auditor may wish to obtain a written representation about the completeness of all minutes of the meetings of shareholders, the board of directors and important committees from the individual responsible for keeping such minutes.

Action if Management Refuses to Provide Representations

15. **If management refuses to provide a representation that the auditor considers necessary, this constitutes a scope limitation and the auditor should express a qualified opinion or a disclaimer of opinion.** In such circumstances, the auditor would evaluate any reliance placed on other representations made by management during the course of the audit and consider if the other implications of the refusal may have any additional effect on the auditor's report.

Appendix

Example of a Management Representation Letter

The following letter is not intended to be a standard letter. Representations by management will vary from one entity to another and from one period to the next.

Although seeking representations from management on a variety of matters may serve to focus management's attention on those matters, and thus cause management to specifically address those matters in more detail than would otherwise be the case, the auditor needs to be cognizant of the limitations of management representations as audit evidence as set out in this ISA.

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 19X1 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of (present fairly, in all material respects,) the financial position of ABC Company as of December 31, 19X1 and of the results of its operations and its cash flows for the year then ended in accordance with (indicate relevant financial reporting framework).

We acknowledge our responsibility for the fair presentation of the financial statements in accordance with (indicate relevant financial reporting framework).¹

We confirm, to the best of our knowledge and belief, the following representations:

Include here representations relevant to the entity. Such representations may include:

- There have been no irregularities involving management or employees who have a significant role in the accounting and internal control systems or that could have a material effect on the financial statements.
- We have made available to you all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors (namely those held on March 15, 19X1 and September 30, 19X1, respectively).
- We confirm the completeness of the information provided regarding the identification of related parties.
- The financial statements are free of material misstatements, including omissions.
- The Company has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of noncompliance. There has been no noncompliance with requirements of regulatory authorities that

¹ If required add "On behalf of the board of directors (or similar body)."

MANAGEMENT REPRESENTATIONS

could have a material effect on the financial statements in the event of noncompliance.

- The following have been properly recorded and when appropriate, adequately disclosed in the financial statements:
 - (a) The identity of, and balances and transactions with, related parties.
 - (b) Losses arising from sale and purchase commitments.
 - (c) Agreements and options to buy back assets previously sold.
 - (d) Assets pledged as collateral.
- We have no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements.
- We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of net realizable value.
- The Company has satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in Note X to the financial statements.
- We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in Note X to the financial statements all guarantees that we have given to third parties.
- Other than . . . described in Note X to the financial statements, there have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or Notes thereto.
- The . . . claim by XYZ Company has been settled for the total sum of XXX which has been properly accrued in the financial statements. No other claims in connection with litigation have been or are expected to be received.
- There are no formal or informal compensating balance arrangements with any of our cash and investment accounts. Except as disclosed in Note X to the financial statements, we have no other line of credit arrangements.
- We have properly recorded or disclosed in the financial statements the capital stock repurchase options and agreements, and capital stock reserved for options, warrants, conversions and other requirements.

(Senior Executive Officer)

(Senior Financial Officer)

INTERNATIONAL STANDARD ON AUDITING 600

USING THE WORK OF ANOTHER AUDITOR

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

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To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

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ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance when an auditor, reporting on the financial statements of an entity, uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity. This ISA does not deal with those instances where two or more auditors are appointed as joint auditors nor does it deal with the auditor's relationship with a predecessor auditor. Further, when the principal auditor concludes that the financial statements of a component are immaterial, the standards in this ISA do not apply. When, however, several components, immaterial in themselves, are together material, the procedures outlined in this ISA would need to be considered.
2. **When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.**
3. "Principal auditor" means the auditor with responsibility for reporting on the financial statements of an entity when those financial statements include financial information of one or more components audited by another auditor.
4. "Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial statements audited by the principal auditor. Other auditors include affiliated firms, whether using the same name or not, and correspondents, as well as unrelated auditors.
5. "Component" means a division, branch, subsidiary, joint venture, associated company or other entity whose financial information is included in financial statements audited by the principal auditor.

Acceptance as Principal Auditor

6. **The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.** For this purpose the principal auditor would consider:
 - (a) The materiality of the portion of the financial statements which the principal auditor audits;
 - (b) The principal auditor's degree of knowledge regarding the business of the components;
 - (c) The risk of material misstatements in the financial statements of the components audited by the other auditor; and
 - (d) The performance of additional procedures as set out in this ISA regarding the components audited by the other auditor resulting in the principal auditor having significant participation in such audit.

The Principal Auditor's Procedures

7. **When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of the specific assignment.** Some of the sources of information for this consideration could be common membership of a professional organization, common membership of, or affiliation, with another firm or reference to the professional organization to which the other auditor belongs. These sources can be supplemented when appropriate by inquiries with other auditors, bankers, *etc.* and by discussions with the other auditor.
8. **The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.**
9. The principal auditor would advise the other auditor of:
 - (a) The independence requirements regarding both the entity and the component and obtain written representation as to compliance with them;
 - (b) The use that is to be made of the other auditor's work and report and make sufficient arrangements for the coordination of their efforts at the initial planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of intercompany transactions that may require disclosure and the timetable for completion of the audit; and
 - (c) The accounting, auditing and reporting requirements and obtain written representation as to compliance with them.
10. The principal auditor might also, for example, discuss with the other auditor the audit procedures applied, review a written summary of the other auditor's procedures (which may be in the form of a questionnaire or checklist) or review working papers of the other auditor. The principal auditor may wish to perform these procedures during a visit to the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of previous audit work of the other auditor.
11. The principal auditor may conclude that it is not necessary to apply procedures such as those described in paragraph 10 because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of the other auditor's practice. For example, when they are affiliated firms the principal auditor and the other auditor may have a continuing, formal relationship providing for procedures that give that audit evidence such as periodic inter-firm review, tests of operating policies and procedures and review of working papers of selected audits.

12. **The principal auditor should consider the significant findings of the other auditor.**
13. The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the component and may also decide that supplementary tests of the records or the financial information of the component are necessary. Such tests may, depending on the circumstances, be performed by the principal auditor or the other auditor.
14. The principal auditor would document in the audit working papers the components whose financial information was audited by other auditors, their significance to the financial statements of the entity as a whole, the names of the other auditors and any conclusions reached that individual components are immaterial. The principal auditor would also document the procedures performed and the conclusions reached. For example, working papers of the other auditor that have been reviewed would be identified and the results of discussions with the other auditor would be recorded. However, the principal auditor need not document the reasons for limiting the procedures in the circumstances described in paragraph 11, provided those reasons are summarized elsewhere in documentation maintained by the principal auditor's firm.

Cooperation Between Auditors

15. **The other auditor, knowing the context in which the principal auditor will use the other auditor's work, should cooperate with the principal auditor.** For example, the other auditor would bring to the principal auditor's attention any aspect of the other auditor's work that cannot be carried out as requested. Similarly, subject to legal and professional considerations, the other auditor will need to be advised of any matters that come to the attention of the principal auditor which may have an important bearing on the other auditor's work.

Reporting Considerations

16. **When the principal auditor concludes that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation in the scope of the audit.**
17. If the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor would consider whether the subject of the modification is of such a nature and significance, in relation to the financial statements of the entity on which the principal auditor is reporting, that a modification of the principal auditor's report is required.

Division of Responsibility

18. While compliance with the guidance in the preceding paragraphs is considered desirable, the local regulations of some countries permit a principal auditor to base the audit opinion on the financial statements taken as a whole solely upon the report of another auditor regarding the audit of one or more components. **When the principal auditor does so, the principal auditor's report should state this fact clearly and should indicate the magnitude of the portion of the financial statements audited by the other auditor.** When the principal auditor makes such a reference in the auditor's report, audit procedures are ordinarily limited to those described in paragraphs 7 and 9.

Public Sector Perspective

1. *The basic principles in this ISA apply to the audit of financial statements in the public sector, however, supplementary guidance on additional considerations when using the work of other auditors in the public sector is needed. For example, the principal auditor in the public sector has to ensure that, where legislation has prescribed compliance with a particular set of auditing standards, the other auditor has complied with those standards. In respect to public sector entities, the Public Sector Committee has supplemented the guidance included in this ISA in its Study 4 "Using the Work of Other Auditors—A Public Sector Perspective."*

INTERNATIONAL STANDARD ON AUDITING 610

CONSIDERING THE WORK OF INTERNAL AUDIT

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance to external auditors in considering the work of internal auditing. This ISA does not deal with instances when personnel from internal auditing assist the external auditor in carrying out external audit procedures. The procedures noted in this ISA need only be applied to internal auditing activities which are relevant to the audit of the financial statements.
2. **The external auditor should consider the activities of internal auditing and their effect, if any, on external audit procedures.**
3. “Internal auditing” means an appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of the accounting and internal control systems.
4. While the external auditor has sole responsibility for the audit opinion expressed and for determining the nature, timing and extent of external audit procedures, certain parts of internal auditing work may be useful to the external auditor.

Scope and Objectives of Internal Auditing

5. The scope and objectives of internal auditing vary widely and depend on the size and structure of the entity and the requirements of its management. Ordinarily, internal auditing activities include one or more of the following:
 - Review of the accounting and internal control systems. The establishment of adequate accounting and internal control systems is a responsibility of management which demands proper attention on a continuous basis. Internal auditing is ordinarily assigned specific responsibility by management for reviewing these systems, monitoring their operation and recommending improvements thereto.
 - Examination of financial and operating information. This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.
 - Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity.
 - Review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements.

Relationship Between Internal Auditing and the External Auditor

6. The role of internal auditing is determined by management, and its objectives differ from those of the external auditor who is appointed to report independently on the financial statements. The internal audit function's objectives vary according to management's requirements. The external auditor's primary concern is whether the financial statements are free of material misstatements.
7. Nevertheless some of the means of achieving their respective objectives are often similar and thus certain aspects of internal auditing may be useful in determining the nature, timing and extent of external audit procedures.
8. Internal auditing is part of the entity. Irrespective of the degree of autonomy and objectivity of internal auditing, it cannot achieve the same degree of independence as required of the external auditor when expressing an opinion on the financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by any use made of internal auditing. All judgments relating to the audit of the financial statements are those of the external auditor.

Understanding and Preliminary Assessment of Internal Auditing

9. **The external auditor should obtain a sufficient understanding of internal audit activities to assist in planning the audit and developing an effective audit approach.**
10. Effective internal auditing will often allow a modification in the nature and timing, and a reduction in the extent of procedures performed by the external auditor but cannot eliminate them entirely. In some cases, however, having considered the activities of internal auditing, the external auditor may decide that internal auditing will have no effect on external audit procedures.
11. **During the course of planning the audit, the external auditor should perform a preliminary assessment of the internal audit function when it appears that internal auditing is relevant to the external audit of the financial statements in specific audit areas.**
12. The external auditor's preliminary assessment of the internal audit function will influence the external auditor's judgment about the use which may be made of internal auditing in modifying the nature, timing and extent of external audit procedures.
13. When obtaining an understanding and performing a preliminary assessment of the internal audit function, the important criteria are:
 - (a) Organizational Status: specific status of internal auditing in the entity and the effect this has on its ability to be objective. In the ideal situation, internal auditing will report to the highest level of management and be free of any other operating responsibility. Any constraints or restrictions

placed on internal auditing by management would need to be carefully considered. In particular, the internal auditors will need to be free to communicate fully with the external auditor.

- (b) **Scope of Function:** the nature and extent of internal auditing assignments performed. The external auditor would also need to consider whether management acts on internal audit recommendations and how this is evidenced.
- (c) **Technical Competence:** whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors. The external auditor may, for example, review the policies for hiring and training the internal auditing staff and their experience and professional qualifications.
- (d) **Due Professional Care:** whether internal auditing is properly planned, supervised, reviewed and documented. The existence of adequate audit manuals, work programs and working papers would be considered.

Timing of Liaison and Coordination

- 14. When planning to use the work of internal auditing, the external auditor will need to consider internal auditing's tentative plan for the period and discuss it at as early a stage as possible. Where the work of internal auditing is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to agree in advance the timing of such work, the extent of audit coverage, test levels and proposed methods of sample selection, documentation of the work performed and review and reporting procedures.
- 15. Liaison with internal auditing is more effective when meetings are held at appropriate intervals during the period. The external auditor would need to be advised of and have access to relevant internal auditing reports and be kept informed of any significant matter that comes to the internal auditor's attention which may affect the work of the external auditor. Similarly, the external auditor would ordinarily inform the internal auditor of any significant matters which may affect internal auditing.

Evaluating and Testing the Work of Internal Auditing

- 16. **When the external auditor intends to use specific work of internal auditing, the external auditor should evaluate and test that work to confirm its adequacy for the external auditor's purposes.**
- 17. The evaluation of specific work of internal auditing involves consideration of the adequacy of the scope of work and related programs and whether the preliminary assessment of the internal auditing remains appropriate. This evaluation may include consideration of whether:

CONSIDERING THE WORK OF INTERNAL AUDITING

- (a) The work is performed by persons having adequate technical training and proficiency as internal auditors and the work of assistants is properly supervised, reviewed and documented;
 - (b) Sufficient appropriate audit evidence is obtained to afford a reasonable basis for the conclusions reached;
 - (c) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and
 - (d) Any exceptions or unusual matters disclosed by internal auditing are properly resolved.
18. The nature, timing and extent of the testing of the specific work of internal auditing will depend on the external auditor's judgment as to the risk and materiality of the area concerned, the preliminary assessment of internal auditing and the evaluation of the specific work by internal auditing. Such tests may include examination of items already examined by internal auditing, examination of other similar items and observation of internal auditing procedures.
19. The external auditor would record conclusions regarding the specific internal auditing work that has been evaluated and tested.

Public Sector Perspective

1. *The basic principles in this ISA apply to the audit of financial statements in the public sector. Supplementary guidance on additional considerations, when considering the work of internal auditing in the public sector is provided in the Public Sector Committee's Study 4 "Using the Work of Other Auditors—A Public Sector Perspective."*

INTERNATIONAL STANDARD ON AUDITING 620

USING THE WORK OF AN EXPERT

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on using the work of an expert as audit evidence.
2. **When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.**
3. “Expert” means a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.
4. The auditor’s education and experience enable the auditor to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation, such as an actuary or engineer.
5. An expert may be:
 - (a) Engaged by the entity;
 - (b) Engaged by the auditor;
 - (c) Employed by the entity; or
 - (d) Employed by the auditor.

When the auditor uses the work of an expert employed by the auditor, that work is used in the employee’s capacity as an expert rather than as an assistant on the audit as contemplated in ISA 220 “Quality Control for Audit Work.” Accordingly, in such circumstances the auditor will need to apply relevant procedures to the employee’s work and findings but will not ordinarily need to assess for each engagement the employee’s skills and competence.

Determining the Need to Use the Work of an Expert

6. During the audit the auditor may need to obtain, in conjunction with the entity or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. Examples are:
 - Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones.
 - Determination of quantities or physical condition of assets, for example, minerals stored in stockpiles, underground mineral and petroleum reserves, and the remaining useful life of plant and machinery.
 - Determination of amounts using specialized techniques or methods, for example, an actuarial valuation.
 - The measurement of work completed and to be completed on contracts in progress.

- Legal opinions concerning interpretations of agreements, statutes and regulations.
7. When determining the need to use the work of an expert, the auditor would consider:
 - (a) The materiality of the financial statement item being considered;
 - (b) The risk of misstatement based on the nature and complexity of the matter being considered; and
 - (c) The quantity and quality of other audit evidence available.

Competence and Objectivity of the Expert

8. **When planning to use the work of an expert, the auditor should assess the professional competence of the expert.** This will involve considering the expert's:
 - (a) Professional certification or licensing by, or membership in, an appropriate professional body; and
 - (b) Experience and reputation in the field in which the auditor is seeking audit evidence.
9. **The auditor should assess the objectivity of the expert.**
10. The risk that an expert's objectivity will be impaired increases when the expert is:
 - (a) Employed by the entity; or
 - (b) Related in some other manner to the entity, for example, by being financially dependent upon or having an investment in the entity.

If the auditor is concerned regarding the competence or objectivity of the expert, the auditor needs to discuss any reservations with management and consider whether sufficient appropriate audit evidence can be obtained concerning the work of an expert. The auditor may need to undertake additional audit procedures or seek audit evidence from another expert (after taking into account the factors in paragraph 7).

Scope of the Expert's Work

11. **The auditor should obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purposes of the audit.** Audit evidence may be obtained through a review of the terms of reference which are often set out in written instructions from the entity to the expert. Such instructions to the expert may cover matters such as:
 - The objectives and scope of the expert's work.
 - A general outline as to the specific matters the auditor expects the expert's report to cover.

- The intended use by the auditor of the expert's work, including the possible communication to third parties of the expert's identity and extent of involvement.
- The extent of the expert's access to appropriate records and files.
- Clarification of the expert's relationship with the entity, if any.
- Confidentiality of the entity's information.
- Information regarding the assumptions and methods intended to be used by the expert and their consistency with those used in prior periods.

In the event that these matters are not clearly set out in written instructions to the expert, the auditor may need to communicate with the expert directly to obtain audit evidence in this regard.

Assessing the Work of the Expert

12. **The auditor should assess the appropriateness of the expert's work as audit evidence regarding the financial statement assertion being considered.** This will involve assessment of whether the substance of the expert's findings is properly reflected in the financial statements or supports the financial statement assertions, and consideration of:
 - Source data used.
 - Assumptions and methods used and their consistency with prior periods.
 - Results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of other audit procedures.
13. When considering whether the expert has used source data which is appropriate in the circumstances, the auditor would consider the following procedures:
 - (a) Making inquiries regarding any procedures undertaken by the expert to establish whether the source data is sufficient, relevant and reliable; and
 - (b) Reviewing or testing the data used by the expert.
14. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor will need to obtain an understanding of the assumptions and methods used and to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures.
15. **If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor should resolve the matter.** This may involve

discussions with the entity and the expert, applying additional procedures, including possibly engaging another expert, or modifying the auditor's report.

Reference to an Expert in the Auditor's Report

16. **When issuing an unmodified auditor's report, the auditor should not refer to the work of an expert.** Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended.
17. If, as a result of the work of an expert, the auditor decides to issue a modified auditor's report, in some circumstances it may be appropriate, in explaining the nature of the modification, to refer to or describe the work of the expert (including the identity of the expert and the extent of the expert's involvement). In these circumstances, the auditor would obtain the permission of the expert before making such a reference. If permission is refused and the auditor believes a reference is necessary, the auditor may need to seek legal advice.

INTERNATIONAL STANDARD ON AUDITING 700

THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor of the financial statements of an entity. Much of the guidance provided can be adapted to auditor reports on financial information other than financial statements.
2. **The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.**
3. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework¹ being either International Accounting Standards (IASs) or relevant national standards or practices. It may also be necessary to consider whether the financial statements comply with statutory requirements.
4. **The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.**

Basic Elements of the Auditor's Report

5. The auditor's report includes the following basic elements, ordinarily in the following layout:
 - (a) Title;
 - (b) Addressee;
 - (c) *Opening or introductory paragraph*
 - (i) Identification of the financial statements audited;
 - (ii) A statement of the responsibility of the entity's management and the responsibility of the auditor;
 - (d) *Scope paragraph (describing the nature of an audit)*
 - (i) A reference to the ISAs or relevant national standards or practices;
 - (ii) A description of the work the auditor performed;
 - (e) *Opinion paragraph* containing²

¹ The Framework of International Standards on Auditing also identifies another authoritative and comprehensive financial reporting framework. Reporting in accordance with this third type of framework is covered in ISA 800, "The Auditor's Report on Special Purpose Audit Engagements."

² Paragraph 5(e) reflects revised text and is effective for audits of financial statements for periods ending on or after September 30, 2002. The original paragraph 5(e) is indicated below:

(e) *Opinion paragraph* containing an expression of opinion on the financial statements;

- (i) A reference to the financial reporting framework used to prepare the financial statements (including identifying the country of origin³ of the financial reporting framework when the framework used is not International Accounting Standards); and
- (ii) An expression of opinion on the financial statements;
- (f) Date of the report;
- (g) Auditor's address; and
- (h) Auditor's signature.

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding and to identify unusual circumstances when they occur.

Title

- 6. **The auditor's report should have an appropriate title.** It may be appropriate to use the term "Independent Auditor" in the title to distinguish the auditor's report from reports that might be issued by others, such as by officers of the entity, the board of directors, or from the reports of other auditors who may not have to abide by the same ethical requirements as the independent auditor.

Addressee

- 7. **The auditor's report should be appropriately addressed as required by the circumstances of the engagement and local regulations.** The report is ordinarily addressed either to the shareholders or the board of directors of the entity whose financial statements are being audited.

Opening or Introductory Paragraph

- 8. **The auditor's report should identify the financial statements of the entity that have been audited, including the date of and period covered by the financial statements.**
- 9. **The report should include a statement that the financial statements are the responsibility of the entity's management⁴ and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.**
- 10. Financial statements are the representations of management. The preparation of such statements requires management to make significant accounting estimates and judgments, as well as to determine the appropriate accounting

³ In some circumstances it also may be necessary to refer to a particular jurisdiction within the country of origin to identify clearly the financial reporting framework used.

⁴ The level of management responsible for the financial statements will vary according to the legal situation in each country.

principles and methods used in preparation of the financial statements. This determination will be made in the context of the financial reporting framework that management chooses, or is required, to use. In contrast, the auditor's responsibility is to audit these financial statements in order to express an opinion thereon.

11. An illustration of these matters in an opening (introductory) paragraph is:
 “We have audited the accompanying⁵ balance sheet of the ABC Company as of December 31, 20X1, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.”

Scope Paragraph

12. **The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with ISAs or in accordance with relevant national standards or practices as appropriate.** “Scope” refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. The reader needs this as an assurance that the audit has been carried out in accordance with established standards or practices. Unless otherwise stated, the auditing standards or practices followed are presumed to be those of the country indicated by the auditor's address.
13. **The report should include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement.**
14. **The auditor's report should describe the audit as including:**
 - (a) **Examining, on a test basis, evidence to support the financial statement amounts and disclosures;**
 - (b) **Assessing the accounting principles used in the preparation of the financial statements;**
 - (c) **Assessing the significant estimates made by management in the preparation of the financial statements; and**
 - (d) **Evaluating the overall financial statement presentation.**
15. **The report should include a statement by the auditor that the audit provides a reasonable basis for the opinion.**
16. An illustration of these matters in a scope paragraph is:
 “We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An

⁵ The reference can be by page numbers.

audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.”

Opinion Paragraph

17. **The opinion paragraph of the auditor’s report should clearly indicate the financial reporting framework used to prepare the financial statements (including identifying the country of origin of the financial reporting framework when the framework used is not International Accounting Standards) and state the auditor’s opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects,) in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements.**⁶
18. The terms used to express the auditor’s opinion are “give a true and fair view” or “present fairly, in all material respects,” and are equivalent. Both terms indicate, amongst other things, that the auditor considers only those matters that are material to the financial statements.
19. The financial reporting framework is determined by IASs, rules issued by recognized standard setting bodies, and the development of general practice within a country, with an appropriate consideration of fairness and with due regard to local legislation. To advise the reader of the context in which the auditor’s opinion is expressed, the auditor’s opinion indicates the framework upon which the financial statements are based. The auditor refers to the financial reporting framework in such terms as:

“...in accordance with International Accounting Standards (or [title of financial reporting framework with reference to the country of origin])....”

This designation will help the user to better understand which financial reporting framework was used in preparing the financial statements. When reporting on financial statements that are prepared specifically for use in another country, the auditor considers whether appropriate disclosure has been made in the financial statements about the financial reporting framework that has been used.⁷

⁶ Paragraph 17 reflects revised text and is effective for audits of financial statements for periods ending on or after September 30, 2002. The original paragraph 17 is indicated below:

The auditor’s report should clearly state the auditor’s opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements.

⁷ Paragraph 19 reflects revised text and is effective for audits of financial statements for periods ending on or after September 30, 2002. The original paragraph 19 is indicated below:

20. In addition to an opinion on the true and fair view (or fair presentation, in all material respects,), the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statutes or law.
21. An illustration of these matters in an opinion paragraph is:
 "In our opinion, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 20X1, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards (or [title of financial reporting framework with reference to the country of origin⁸]) (and comply with ...⁹)."¹⁰
22. [Paragraph deleted by revision to ISA 700 effective for audits of financial statements for periods ending on or after September 30 2002.]¹¹

Date of Report

23. **The auditor should date the report as of the completion date of the audit.** This informs the reader that the auditor has considered the effect on the financial statements and on the report of events and transactions of which the auditor became aware and that occurred up to that date.
24. **Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.**

The financial reporting framework is determined by IASs, rules issued by professional bodies, and the development of general practice within a country, with an appropriate consideration of fairness and with due regard to local legislation. To advise the reader of the context in which "fairness" is expressed, the auditor's opinion would indicate the framework upon which the financial statements are based by using words such as "in accordance with (indicate IASs or relevant national standards)."

⁸ See footnote 3.

⁹ Refer to relevant statutes or law.

¹⁰ The words "with reference to the country of origin" have been added to the original text of this paragraph. The revised text is effective for audits of financial statements for periods ending on or after September 20, 2002.

¹¹ The deleted paragraph 22 is indicated below:

In any situation where it is not evident which country's accounting principles have been used, the country should be stated. When reporting on financial statements that are distributed extensively outside the country of origin, it is recommended that the auditor refer to the standards of the country of origin in the auditor's report, such as:

"...in accordance with accounting principles generally accepted in country A..."

This designation will help the user to better understand which accounting principles were used in preparing the financial statements. When reporting on financial statements that are prepared specifically for use in another country (e.g., where the statements have been translated into the language and currency of another country in a cross-border financing), the auditor will consider the need to refer to the accounting principles of the country of origin where prepared, and consider whether appropriate disclosure has been made in the statements.

Auditor's Address

25. **The report should name a specific location, which is ordinarily the city where the auditor maintains the office that has responsibility for the audit.**

Auditor's Signature

26. **The report should be signed in the name of the audit firm, the personal name of the auditor or both, as appropriate.** The auditor's report is ordinarily signed in the name of the firm because the firm assumes responsibility for the audit.

The Auditor's Report

27. **An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects,) in accordance with the identified financial reporting framework.** An unqualified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.
28. The following is an illustration of the entire auditor's report incorporating the basic elements set forth and illustrated above. This report illustrates the expression of an unqualified opinion.

"AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying¹² balance sheet of the ABC Company as of December 31, 20X1, and the related statements of income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the

¹² See footnote 5.

Company as of December 31, 20X1, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards (or [title of financial reporting framework with reference to the country of origin¹³]) (and comply with ...¹⁴).¹⁵

AUDITOR

Date
Address”

Modified Reports

29. An auditor’s report is considered to be modified in the following situations:

Matters That Do Not Affect the Auditor’s Opinion

- (a) emphasis of matter

Matters That Do Affect the Auditor’s Opinion

- (a) qualified opinion,
(b) disclaimer of opinion, or
(c) adverse opinion.

Uniformity in the form and content of each type of modified report will further the user’s understanding of such reports. Accordingly, this ISA includes suggested wording to express an unqualified opinion as well as examples of modifying phrases for use when issuing modified reports.

Matters That Do Not Affect the Auditor’s Opinion

30. In certain circumstances, an auditor’s report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor’s opinion. The paragraph would preferably be included after the opinion paragraph and would ordinarily refer to the fact that the auditor’s opinion is not qualified in this respect.
31. **The auditor should modify the auditor’s report by adding a paragraph to highlight a material matter regarding a going concern problem.**
32. **The auditor should consider modifying the auditor’s report by adding a paragraph if there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements.** An uncertainty is a matter whose

¹³ See footnote 3.

¹⁴ See footnote 9.

¹⁵ See footnote 10.

outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

33. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report follows:

"In our opinion ... (remaining words are the same as illustrated in the opinion paragraph—paragraph 28 above).

Without qualifying our opinion we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements."

(An illustration of an emphasis of matter paragraph relating to going concern is set out in ISA 570, "Going Concern.")

34. The addition of a paragraph emphasizing a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.
35. In addition to the use of an emphasis of matter paragraph for matters that affect the financial statements, the auditor may also modify the auditor's report by using an emphasis of matter paragraph, preferably after the opinion paragraph, to report on matters other than those affecting the financial statements. For example, if an amendment to other information in a document containing audited financial statements is necessary and the entity refuses to make the amendment, the auditor would consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency. An emphasis of matter paragraph may also be used when there are additional statutory reporting responsibilities.

Matters That Do Affect the Auditor's Opinion

36. An auditor may not be able to express an unqualified opinion when either of the following circumstances exist and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:
- (a) There is a limitation on the scope of the auditor's work; or
 - (b) There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed more fully in paragraphs 41–46.

37. **A *qualified opinion* should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being ‘except for’ the effects of the matter to which the qualification relates.**
38. **A *disclaimer of opinion* should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.**
39. **An *adverse opinion* should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.**
40. **Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements.** Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

Circumstances That May Result in Other Than an Unqualified Opinion

Limitation on Scope

41. A limitation on the scope of the auditor’s work may sometimes be imposed by the entity (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary). However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor would ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor’s statutory duties.
42. A scope limitation may be imposed by circumstances (for example, when the timing of the auditor’s appointment is such that the auditor is unable to observe the counting of physical inventories). It may also arise when, in the opinion of the auditor, the entity’s accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable.

In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

43. **When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.**
44. Illustrations of these matters are set out below.

Limitation on Scope—Qualified Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph—paragraph 28 above).

Except as discussed in the following paragraph, we conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph—paragraph 28 above).

We did not observe the counting of the physical inventories as of December 31, 20X1, since that date was prior to the time we were initially engaged as auditors for the Company. Owing to the nature of the Company's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and ... (remaining words are the same as illustrated in the opinion paragraph—paragraph 28 above)."

Limitation on Scope—Disclaimer of Opinion

"We were engaged to audit the accompanying balance sheet of the ABC Company as of December 31, 20X1, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. (Omit the sentence stating the responsibility of the auditor).

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows:)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the Company.

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements."

Disagreement with Management

45. The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. **If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.**
46. Illustrations of these matters are set out below.

Disagreement on Accounting Policies—Inappropriate Accounting Method—Qualified Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph—paragraph 28 above).

We conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph—paragraph 28 above).

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards. The provision for the year ended December 31, 20X1, should be xxx based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the fixed assets should be reduced by accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx, respectively.

In our opinion, *except for the effect on the financial statements of the matter referred to in the preceding paragraph*, the financial statements give a true and ... (remaining words are the same as illustrated in the opinion paragraph—paragraph 28 above).”

Disagreement on Accounting Policies—Inadequate Disclosure—Qualified Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph—paragraph 28 above).

We conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph—paragraph 28 above).

On January 15, 20X2, the Company issued debentures in the amount of xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 19X1. In our opinion, disclosure of this information is required by ...¹⁶.

In our opinion, *except for the omission of the information included in the preceding paragraph*, the financial statements give a true and ...

¹⁶ See footnote 9.

(remaining words are the same as illustrated in the opinion paragraph—paragraph 28 above).”

Disagreement on Accounting Policies—Inadequate Disclosure—Adverse Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph—paragraph 28 above).

We conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph—paragraph 28 above).

(Paragraph(s) discussing the disagreement).

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of (or do not ‘present fairly’) the financial position of the Company as of December 20, 19X1, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards (or [title of financial reporting framework with reference to the country of origin¹⁷]) (and do not comply with ...¹⁸). ”¹⁹

Effective Date²⁰

47. This revised standard is effective for audits of financial statements for periods ending on or after September 30, 2002. Earlier application is encouraged.

¹⁷ See footnote 3.

¹⁸ See footnote 9.

¹⁹ See footnote 10.

²⁰ The original ISA 700 did not include an effective date.

Public Sector Perspective

1. *While the basic principles contained in this ISA apply to the audit of financial statements in the public sector, the legislation giving rise to the audit mandate may specify the nature, content and form of the auditor's report.*
2. *This ISA does not address the form and content of the auditor's report in circumstances where financial statements are prepared in conformity with a disclosed basis of accounting, whether mandated by legislation or ministerial (or other) directive, and that basis results in financial statements which are misleading.*
3. *Paragraph 17 of this standard requires the auditor to indicate clearly the financial reporting framework used to prepare the financial statements. Where a public sector entity has adopted International Public Sector Accounting Standards as the financial reporting framework, the auditor should clearly state that fact in the audit opinion. For example:*

*"In our opinion, the financial statements present fairly, in all material respects, the financial position of the [public sector entity] as of December 31, 20X1 and of its financial performance and its cash flows for the year then ended in accordance with International Public Sector Accounting Standards."*²¹

²¹ The original ISA 700 did not contain this paragraph, which is effective for audits of financial statements for periods ending on or after September 30, 2002.

INTERNATIONAL STANDARD ON AUDITING 710

COMPARATIVES

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibilities regarding comparatives. It does not deal with situations when summarized financial statements are presented with the audited financial statements (for guidance see ISA 720 "Other Information in Documents Containing Audited Financial Statements," and ISA 800 "The Auditor's Report on Special Purpose Audit Engagements").
2. **The auditor should determine whether the comparatives comply in all material respects with the financial reporting framework relevant to the financial statements being audited.**
3. The existence of differences in financial reporting frameworks between countries results in comparative financial information being presented differently in each framework. Comparatives in financial statements, for example, may present amounts (such as financial position, results of operations, cash flows) and appropriate disclosures of an entity for more than one period, depending on the framework. The frameworks and methods of presentation are referred to in this ISA as follows:
 - (a) *Corresponding figures* where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures" for the purpose of this ISA). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures; and
 - (b) *Comparative financial statements* where amounts and other disclosures for the preceding period are included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.

(Refer to Appendix 1 to this ISA for discussion of these different reporting frameworks.)
4. Comparatives are presented in compliance with the relevant financial reporting framework. The essential audit reporting differences are that:
 - (a) For corresponding figures, the auditor's report only refers to the financial statements of the current period; whereas
 - (b) For comparative financial statements, the auditor's report refers to each period that financial statements are presented.
5. This ISA provides guidance on the auditor's responsibilities for comparatives and for reporting on them under the two frameworks in separate sections.

Corresponding Figures

The Auditor's Responsibilities

6. **The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the relevant financial reporting framework.** The extent of audit procedures performed on the corresponding figures is significantly less than for the audit of the current period figures and is ordinarily limited to ensuring that the corresponding figures have been correctly reported and are appropriately classified. This involves the auditor assessing whether:
 - (a) Accounting policies used for the corresponding figures are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and
 - (b) Corresponding figures agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and/or disclosures have been made.
7. When the financial statements of the prior period have been audited by another auditor, the incoming auditor assesses whether the corresponding figures meet the conditions specified in paragraph 6 above and also follows the guidance in ISA 510 "Initial Engagements—Opening Balances."
8. When the financial statements of the prior period were not audited, the incoming auditor nonetheless assesses whether the corresponding figures meet the conditions specified in paragraph 6 above and also follows the guidance in ISA 510 "Initial Engagements—Opening Balances."
9. If the auditor becomes aware of a possible material misstatement in the corresponding figures when performing the current period audit, the auditor performs such additional procedures as are appropriate in the circumstances.

Reporting

10. **When the comparatives are presented as corresponding figures, the auditor should issue an audit report in which the comparatives are not specifically identified because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.**
11. The auditor's report would make specific reference to the corresponding figures only in the circumstances described in paragraphs 12, 13, 15(b), and 16 through 19.
12. **When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is:**

- (a) **Unresolved, and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or**
 - (b) **Unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.**
13. When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is resolved and properly dealt with in the financial statements, the current report does not ordinarily refer to the previous modification. However, if the matter is material to the current period, the auditor may include an emphasis of matter paragraph dealing with the situation.
14. In performing the audit of the current period financial statements, the auditor, in certain unusual circumstances, may become aware of a material misstatement that affects the prior period financial statements on which an unmodified report has been previously issued.
15. **In such circumstances, the auditor should consider the guidance in ISA 560 "Subsequent Events" and:**
- (a) **If the prior period financial statements have been revised and reissued with a new auditor's report, the auditor should be satisfied that the corresponding figures agree with the revised financial statements; or**
 - (b) **If the prior period financial statements have not been revised and reissued, and the corresponding figures have not been properly restated and/or appropriate disclosures have not been made, the auditor should issue a modified report on the current period financial statements modified with respect to the corresponding figures included therein.**
16. If, in the circumstances described in paragraph 14, the prior period financial statements have not been revised and an auditor's report has not been reissued, but the corresponding figures have been properly restated and/or appropriate disclosures have been made in the current period financial statements, the auditor may include an emphasis of matter paragraph describing the circumstances and referencing to the appropriate disclosures. In this regard, the auditor also considers the guidance in ISA 560 "Subsequent Events."

Incoming Auditor—Additional Requirements

Prior Period Financial Statements Audited by Another Auditor

17. In some jurisdictions, the incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming

auditor's report for the current period. **When the auditor decides to refer to another auditor, the incoming auditor's report should indicate:**

- (a) **That the financial statements of the prior period were audited by another auditor;**
- (b) **The type of report issued by the predecessor auditor and, if the report was modified, the reasons therefor; and**
- (c) **The date of that report.**

Prior Period Financial Statements Not Audited

- 18. **When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited.** Such a statement does not, however, relieve the auditor of the requirement to perform appropriate procedures regarding opening balances of the current period. Clear disclosure in the financial statements that the corresponding figures are unaudited is encouraged.
- 19. **In situations where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or if management refuses to do so, appropriately modify the report.**

Comparative Financial Statements

The Auditor's Responsibilities

- 20. **The auditor should obtain sufficient appropriate audit evidence that the comparative financial statements meet the requirements of the relevant financial reporting framework.** This involves the auditor assessing whether:
 - (a) Accounting policies of the prior period are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and
 - (b) Prior period figures presented agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and disclosures have been made.
- 21. When the financial statements of the prior period have been audited by another auditor, the incoming auditor assesses whether the comparative financial statements meet the conditions in paragraph 20 above and also follows the guidance in ISA 510 "Initial Engagements—Opening Balances."
- 22. When the financial statements of the prior period were not audited, the incoming auditor nonetheless assesses whether the comparative financial statements meet the conditions specified in paragraph 20 above and also follows the guidance in ISA 510 "Initial Engagements—Opening Balances."

23. If the auditor becomes aware of a possible material misstatement in the prior year figures when performing the current period audit, the auditor performs such additional procedures as are appropriate in the circumstances.

Reporting

24. **When the comparatives are presented as comparative financial statements, the auditor should issue a report in which the comparatives are specifically identified because the auditor's opinion is expressed individually on the financial statements of each period presented.** Since the auditor's report on comparative financial statements applies to the individual financial statements presented, the auditor may express a qualified or adverse opinion, disclaim an opinion, or include an emphasis of matter paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements.
25. **When reporting on the prior period financial statements in connection with the current year's audit, if the opinion on such prior period financial statements is different from the opinion previously expressed, the auditor should disclose the substantive reasons for the different opinion in an emphasis of matter paragraph.** This may arise when the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period.

Incoming Auditor—Additional Requirements

Prior Period Financial Statements Audited by Another Auditor

26. **When the financial statements of the prior period were audited by another auditor,**
- (a) **The predecessor auditor may reissue the audit report on the prior period with the incoming auditor only reporting on the current period; or**
 - (b) **The incoming auditor's report should state that the prior period was audited by another auditor and the incoming auditor's report should indicate:**
 - (i) **That the financial statements of the prior period were audited by another auditor;**
 - (ii) **The type of report issued by the predecessor auditor and if the report was modified, the reasons therefor; and**
 - (iii) **The date of that report.**
27. In performing the audit on the current period financial statements, the incoming auditor, in certain unusual circumstances, may become aware of a material misstatement that affects the prior period financial statements on which the predecessor auditor had previously reported without modification.

28. **In these circumstances, the incoming auditor should discuss the matter with management and, after having obtained management's authorization, contact the predecessor auditor and propose that the prior period financial statements be restated. If the predecessor agrees to reissue the audit report on the restated financial statements of the prior period, the auditor should follow the guidance in paragraph 26.**
29. If, in the circumstances discussed in paragraph 27, the predecessor does not agree with the proposed restatement or refuses to reissue the audit report on the prior period financial statements, the introductory paragraph of the auditor's report may indicate that the predecessor auditor reported on the financial statements of the prior period before restatement. In addition, if the incoming auditor is engaged to audit and applies sufficient procedures to be satisfied as to the appropriateness of the restatement adjustment, the auditor may also include the following paragraph in the report:

We also audited the adjustments described in Note X that were applied to restate the 19X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

Prior Period Financial Statements Not Audited

30. **When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the comparative financial statements are unaudited.** Such a statement does not, however, relieve the auditor of the requirement to carry out appropriate procedures regarding opening balances of the current period. Clear disclosure in the financial statements that the comparative financial statements are unaudited is encouraged.
31. **In situations where the incoming auditor identifies that the prior year unaudited figures are materially misstated, the auditor should request management to revise the prior year's figures or if management refuses to do so, appropriately modify the report.**

Effective Date

32. This ISA is effective for reports issued or reissued on or after July 1, 1997. Earlier application is permitted.

Appendix 1

Discussion of Financial Reporting Frameworks for Comparatives

1. Comparatives covering one or more preceding periods provide the users of financial statements with information necessary to identify trends and changes affecting an entity over a period of time.
2. Under financial reporting frameworks (both implicit and explicit) prevailing in a number of countries, comparability and consistency are desirable qualities for financial information. Defined in broadest terms, comparability is the quality of having certain characteristics in common and comparison is normally a quantitative assessment of the common characteristics. Consistency is a quality of the relationship between two accounting numbers. Consistency (for example, consistency in the use of accounting principles from one period to another, the consistency of the length of the reporting period, *etc.*) is a prerequisite for true comparability.
3. There are two broad financial reporting frameworks for comparatives: the corresponding figures and the comparative financial statements.
4. Under the corresponding figures framework, the corresponding figures for the prior period(s) are an integral part of the current period financial statements and have to be read in conjunction with the amounts and other disclosures relating to the current period. The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.
5. Under the comparative financial statements framework, the comparative financial statements for the prior period(s) are considered separate financial statements. Accordingly, the level of information included in those comparative financial statements (including all statement amounts, disclosures, footnotes and other explanatory statements to the extent that they continue to be of significance) approximates that of the financial statements of the current period.

Appendix 2

Example Auditor's Reports

Example A *Corresponding Figures: Example Report for the circumstances described in paragraph 12a*

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying¹ balance sheet of the ABC Company as of December 31, 19X1, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards (or refer to relevant national standards). This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by XXX in 19X1 and XXX in 19X0, the fixed assets should be reduced by accumulated depreciation of XXX in 19X1 and XXX in 19X0, and the accumulated loss should be increased by XXX in 19X1 and XXX in 19X0.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 19X1, and of the results of its operations and its cash flows for the year then ended in accordance with ...² (and comply with ...³).

AUDITOR

Date

Address

¹ The reference can be by page numbers.

² Indicate International Accounting Standards or relevant national standards.

³ Reference to relevant statutes or laws.

Example B *Corresponding Figures: Example Report for the circumstances described in paragraph 12b*

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying⁴ balance sheet of the ABC Company as of December 31, 19X1, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Because we were appointed auditors of the Company during 19X0, we were not able to observe the counting of the physical inventories at the beginning of that (period) or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories enter into the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening retained earnings might be necessary for 19X0. Our audit report on the financial statements for the (period) ended (balance sheet date) 19X0 was modified accordingly.

In our opinion, except for the effect on the corresponding figures for 19X0 of the adjustments, if any, to the results of operations for the (period) ended 19X0, which we might have determined to be necessary had we been able to observe beginning inventory quantities as at ..., the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 19X1, and of the results of its operations and its cash flows for the year then ended in accordance with ...⁵ (and comply with⁶).

AUDITOR

Date

Address

⁴ The reference can be by page numbers.

⁵ Indicate International Accounting Standards or relevant national standards.

⁶ Reference to relevant statutes or laws.

Example C *Comparative Financial Statements: Example Report for the circumstances described in paragraph 24*

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying⁷ balance sheets of the ABC Company as of December 31, 19X1 and 19X0, and the related statements of income and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards (or refer to relevant national standards). Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by XXX in 19X1 and XXX in 19X0, the fixed assets should be reduced by accumulated depreciation of XXX in 19X1 and XXX in 19X0, and the accumulated loss should be increased by XXX in 19X1 and XXX in 19X0.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 19X1 and 19X0, and of the results of its operations and its cash flows for the years then ended in accordance with ...⁸ (and comply with⁹).

AUDITOR

Date
Address

⁷ The reference can be by page numbers.

⁸ Indicate International Accounting Standards or relevant national standards.

⁹ Reference to relevant statutes or laws.

Example D *Corresponding Figures: Example Report for the circumstances described in paragraph 17*

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying¹⁰ balance sheet of the ABC Company as of December 31, 19X1, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Company as of December 31, 19X0, were audited by another auditor whose report dated March 31, 19X1, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 19X1, and of the results of its operations and its cash flows for the year then ended in accordance with ...¹¹ (and comply with ...¹²).

AUDITOR

Date

Address

¹⁰ The reference can be by page numbers.

¹¹ Indicate International Accounting Standards or relevant national standards.

¹² Reference to relevant statutes or laws.

Example E *Comparative Financial Statements: Example Report for the circumstances described in paragraph 26b*

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying¹³ balance sheet of the ABC Company as of December 31, 19X1, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Company as of December 31, 19X0, were audited by another auditor whose report dated March 31, 19X1, expressed a qualified opinion due to their disagreement as to the adequacy of the provision for doubtful receivables.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The receivables referred to above are still outstanding at December 31, 19X1 and no provision for potential loss has been made in the financial statements. Accordingly, the provision for doubtful receivables at December 31, 19X1 and 19X0 should be increased by XXX, the net profit for 19X0 decreased by XXX and the retained earnings at December 31, 19X1 and 19X0 reduced by XXX.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the 19X1 financial statements referred to above give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 19X1, and of the results of its operations and its cash flows for the year then ended in accordance with ...¹⁴ (and comply with ...¹⁵).

AUDITOR

Date
Address

¹³ The reference can be by page numbers.

¹⁴ Indicate International Accounting Standards or relevant national standards.

¹⁵ Reference to relevant statutes or laws.

INTERNATIONAL STANDARD ON AUDITING 720

OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements. This ISA applies when an annual report is involved, however it may also apply to other documents, such as those used in securities offerings.
2. **The auditor should read the other information to identify material inconsistencies with the audited financial statements.**
3. A "material inconsistency" exists when other information contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.
4. An entity ordinarily issues on an annual basis a document which includes its audited financial statements together with the auditor's report thereon. This document is frequently referred to as the "annual report." In issuing such a document, an entity may also include, either by law or custom, other financial and non-financial information. For the purpose of this ISA, such other financial and non-financial information is called "other information."
5. Examples of other information include a report by management or the board of directors on operations, financial summaries or highlights, employment data, planned capital expenditures, financial ratios, names of officers and directors and selected quarterly data.
6. In certain circumstances, the auditor has a statutory or contractual obligation to report specifically on other information. In other circumstances, the auditor has no such obligation. However, the auditor needs to give consideration to such other information when issuing a report on the financial statements, as the credibility of the audited financial statements may be undermined by inconsistencies which may exist between the audited financial statements and other information.
7. Some jurisdictions require the auditor to apply specific procedures to certain of the other information, for example, required supplementary data and interim financial information. If such other information is omitted or contains deficiencies, the auditor may be required to refer to the matter in the auditor's report.
8. When there is an obligation to report specifically on other information, the auditor's responsibilities are determined by the nature of the engagement and by local legislation and professional standards. When such responsibilities involve the review of other information, the auditor will need to follow the guidance on review engagements in the appropriate ISAs.

Access to Other Information

9. In order that an auditor can consider other information included in the annual report, timely access to such information will be required. The auditor therefore needs to make appropriate arrangements with the entity to obtain such information prior to the date of the auditor's report. In certain circumstances, all the other information may not be available prior to such date. In these circumstances, the auditor would follow the guidance in paragraphs 20 to 23.

Consideration of Other Information

10. The objective and scope of an audit of financial statements are formulated on the premise that the auditor's responsibility is restricted to information identified in the auditor's report. Accordingly, the auditor has no specific responsibility to determine that other information is properly stated.

Material Inconsistencies

11. **If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be amended.**
12. **If an amendment is necessary in the audited financial statements and the entity refuses to make the amendment, the auditor should express a qualified or adverse opinion.**
13. **If an amendment is necessary in the other information and the entity refuses to make the amendment, the auditor should consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency or taking other actions.** The actions taken, such as not issuing the auditor's report or withdrawing from the engagement, will depend upon the particular circumstances and the nature and significance of the inconsistency. The auditor would also consider obtaining legal advice as to further action.

Material Misstatements of Fact

14. While reading the other information for the purpose of identifying material inconsistencies, the auditor may become aware of an apparent material misstatement of fact.
15. For the purpose of this ISA, a "material misstatement of fact" in other information exists when such information, not related to matters appearing in the audited financial statements, is incorrectly stated or presented.
16. **If the auditor becomes aware that the other information appears to include a material misstatement of fact, the auditor should discuss the matter with the entity's management.** When discussing the matter with the entity's management, the auditor may not be able to evaluate the validity of the

other information and management's responses to the auditor's inquiries, and would need to consider whether valid differences of judgment or opinion exist.

17. **When the auditor still considers that there is an apparent misstatement of fact, the auditor should request management to consult with a qualified third party, such as the entity's legal counsel and should consider the advice received.**
18. **If the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor should consider taking further appropriate action.** The actions taken could include such steps as notifying those persons ultimately responsible for the overall direction of the entity in writing of the auditor's concern regarding the other information and obtaining legal advice.

Availability of Other Information After the Date of the Auditor's Report

19. When all the other information is not available to the auditor prior to the date of the auditor's report, the auditor would read the other information at the earliest possible opportunity thereafter to identify material inconsistencies.
20. If, on reading the other information, the auditor identifies a material inconsistency or becomes aware of an apparent material misstatement of fact, the auditor would determine whether the audited financial statements or the other information need revision.
21. When revision of the audited financial statements is appropriate, the guidance in ISA 560 "Subsequent Events" would be followed.
22. When revision of the other information is necessary and the entity agrees to make the revision, the auditor would carry out the procedures necessary under the circumstances. The procedures may include reviewing the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor's report thereon and the other information are informed of the revision.
23. **When revision of the other information is necessary but management refuses to make the revision, the auditor should consider taking further appropriate action.** The actions taken could include such steps as notifying those persons ultimately responsible for the overall direction of the entity in writing of the auditor's concern regarding the other information and obtaining legal advice.

Public Sector Perspective

1. *This ISA is applicable in the context of the audit of financial statements. In the public sector, the auditor may often have a statutory or contractual obligation to report specifically on other information. As paragraph 8 of this ISA indicates, the procedures stated in this ISA would not be adequate to satisfy legislative or other audit requirements related to, for example, the expression*

of an opinion on the reliability of performance indicators and other information contained in the annual report. It would be inappropriate to apply this ISA in circumstances where the auditor does have an obligation to express an opinion on such information. In the absence of specific auditing requirements in relation to “other information,” the broad principles contained in this ISA are applicable.

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THE AUDITOR'S REPORT ON SPECIAL PURPOSE AUDIT ENGAGEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance in connection with special purpose audit engagements including:
 - Financial statements prepared in accordance with a comprehensive basis of accounting other than International Accounting Standards or national standards;
 - Specified accounts, elements of accounts, or items in a financial statement (hereafter referred to as reports on a component of financial statements);
 - Compliance with contractual agreements; and
 - Summarized financial statements.

This ISA does not apply to review, agreed-upon procedures or compilation engagements.

2. **The auditor should review and assess the conclusions drawn from the audit evidence obtained during the special purpose audit engagement as the basis for an expression of opinion. The report should contain a clear written expression of opinion.**

General Considerations

3. The nature, timing and extent of work to be performed in a special purpose audit engagement will vary with the circumstances. **Before undertaking a special purpose audit engagement, the auditor should ensure there is agreement with the client as to the exact nature of the engagement and the form and content of the report to be issued.**
4. In planning the audit work, the auditor will need a clear understanding of the purpose for which the information being reported on is to be used, and who is likely to use it. To avoid the possibility of the auditor's report being used for purposes for which it was not intended, the auditor may wish to indicate in the report the purpose for which the report is prepared and any restrictions on its distribution and use.
5. **The auditor's report on a special purpose audit engagement, except for a report on summarized financial statements, should include the following basic elements, ordinarily in the following layout:**
 - (a) **Title¹ ;**
 - (b) **Addressee;**
 - (c) **Opening or introductory paragraph**

¹ It may be appropriate to use the term "Independent Auditor" in the title to distinguish the auditor's report from reports that might be issued by others, such as officers of the entity, or from the reports of other auditors who may not have to abide by the same ethical requirements as the independent auditor.

- (i) **Identification of the financial information audited; and**
- (ii) **A statement of the responsibility of the entity's management and the responsibility of the auditor;**
- (d) **A scope paragraph (describing the nature of an audit)**
 - (i) **The reference to the ISAs applicable to special purpose audit engagements or relevant national standards or practices; and**
 - (ii) **A description of the work the auditor performed;**
- (e) **Opinion paragraph containing an expression of opinion on the financial information;**
- (f) **Date of the report;**
- (g) **Auditor's address; and**
- (h) **Auditor's signature.**

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding.

6. In the case of financial information to be supplied by an entity to government authorities, trustees, insurers and other entities there may be a prescribed format for the auditor's report. Such prescribed reports may not conform to the requirements of this ISA. For example, the prescribed report may require a certification of fact when an expression of opinion is appropriate, may require an opinion on matters outside the scope of the audit or may omit essential wording. **When requested to report in a prescribed format, the auditor should consider the substance and wording of the prescribed report and, when necessary, should make appropriate changes to conform to the requirements of this ISA, either by rewording the form or by attaching a separate report.**
7. When the information on which the auditor has been requested to report is based on the provisions of an agreement, the auditor needs to consider whether any significant interpretations of the agreement have been made by management in preparing the information. An interpretation is significant when adoption of another reasonable interpretation would have produced a material difference in the financial information.
8. **The auditor should consider whether any significant interpretations of an agreement on which the financial information is based are clearly disclosed in the financial information.** The auditor may wish to make reference in the auditor's report on the special purpose audit engagement to the note within the financial information that describe such interpretations.

Reports on Financial Statements Prepared in Accordance with a Comprehensive Basis of Accounting other than International Accounting Standards or National Standards

9. A comprehensive basis of accounting comprises a set of criteria used in preparing financial statements which applies to all material items and which has substantial support. Financial statements may be prepared for a special purpose in accordance with a comprehensive basis of accounting other than International Accounting Standards or relevant national standards (referred to herein as an “other comprehensive basis of accounting”). A conglomeration of accounting conventions devised to suit individual preference is not a comprehensive basis of accounting. Other comprehensive financial reporting frameworks may include:
 - That used by an entity to prepare its income tax return.
 - The cash receipts and disbursements basis of accounting.
 - The financial reporting provisions of a government regulatory agency.
10. **The auditor’s report on financial statements prepared in accordance with another comprehensive basis of accounting should include a statement that indicates the basis of accounting used or should refer to the note to the financial statements giving that information. The opinion should state whether the financial statements are prepared, in all material respects, in accordance with the identified basis of accounting.** The terms used to express the auditor’s opinion are “give a true and fair view” or “present fairly, in all material respects,” which are equivalent terms. Appendix 1 to this ISA gives examples of auditor’s reports on financial statements prepared in accordance with an other comprehensive basis of accounting.
11. The auditor would consider whether the title of, or a note to, the financial statements makes it clear to the reader that such statements are not prepared in accordance with International Accounting Standards or national standards. For example, a tax basis financial statement might be entitled “Statement of Income and Expenses—Income Tax Basis.” **If the financial statements prepared on an other comprehensive basis are not suitably titled or the basis of accounting is not adequately disclosed, the auditor should issue an appropriately modified report.**

Reports on a Component of Financial Statements

12. The auditor may be requested to express an opinion on one or more components of financial statements, for example, accounts receivable, inventory, an employee’s bonus calculation or a provision for income taxes. This type of engagement may be undertaken as a separate engagement or in conjunction with an audit of the entity’s financial statements. However, this type of engagement does not result in a report on the financial statements taken as a whole and, accordingly, the auditor would express an opinion only as to

whether the component audited is prepared, in all material respects, in accordance with the identified basis of accounting.

13. Many financial statement items are interrelated, for example, sales and receivables, and inventory and payables. Accordingly, when reporting on a component of financial statements, the auditor will sometimes be unable to consider the subject of the audit in isolation and will need to examine certain other financial information. **In determining the scope of the engagement, the auditor should consider those financial statement items that are interrelated and which could materially affect the information on which the audit opinion is to be expressed.**
14. **The auditor should consider the concept of materiality in relation to the component of financial statements being reported upon.** For example, a particular account balance provides a smaller base against which to measure materiality compared with the financial statements taken as a whole. Consequently, the auditor's examination will ordinarily be more extensive than if the same component were to be audited in connection with a report on the entire financial statements.
15. To avoid giving the user the impression that the report relates to the entire financial statements, the auditor would advise the client that the auditor's report on a component of financial statements is not to accompany the financial statements of the entity.
16. **The auditor's report on a component of financial statements should include a statement that indicates the basis of accounting in accordance with which the component is presented or refers to an agreement that specifies the basis. The opinion should state whether the component is prepared, in all material respects, in accordance with the identified basis of accounting.** Appendix 2 to this ISA gives examples of audit reports on components of financial statements.
17. **When an adverse opinion or disclaimer of opinion on the entire financial statements has been expressed, the auditor should report on components of the financial statements only if those components are not so extensive as to constitute a major portion of the financial statements.** To do otherwise may overshadow the report on the entire financial statements.

Reports on Compliance with Contractual Agreements

18. The auditor may be requested to report on an entity's compliance with certain aspects of contractual agreements, such as bond indentures or loan agreements. Such agreements ordinarily require the entity to comply with a variety of covenants involving such matters as payments of interest, maintenance of predetermined financial ratios, restriction of dividend payments and the use of the proceeds of sales of property.
19. **Engagements to express an opinion as to an entity's compliance with contractual agreements should be undertaken only when the overall**

aspects of compliance relate to accounting and financial matters within the scope of the auditor's professional competence. However, when there are particular matters forming part of the engagement that are outside the auditor's expertise, the auditor would consider using the work of an expert.

20. **The report should state whether, in the auditor's opinion, the entity has complied with the particular provisions of the agreement.** Appendix 3 to this ISA gives examples of auditor's reports on compliance given in a separate report and in a report accompanying financial statements.

Reports on Summarized Financial Statements

21. An entity may prepare financial statements summarizing its annual audited financial statements for the purpose of informing user groups interested in the highlights only of the entity's financial position and the results of its operations. **Unless the auditor has expressed an audit opinion on the financial statements from which the summarized financial statements were derived, the auditor should not report on summarized financial statements.**
22. Summarized financial statements are presented in considerably less detail than annual audited financial statements. Therefore, such financial statements need to clearly indicate the summarized nature of the information and caution the reader that, for a better understanding of an entity's financial position and the results of its operations, summarized financial statements are to be read in conjunction with the entity's most recent audited financial statements which include all disclosures required by the relevant financial reporting framework.
23. Summarized financial statements need to be appropriately titled to identify the audited financial statements from which they have been derived, for example, "Summarized Financial Information Prepared from the Audited Financial Statements for the Year Ended December 31, 19X1."
24. Summarized financial statements do not contain all the information required by the financial reporting framework used for the annual audited financial statements. Consequently, wording such as "true and fair" or "present fairly, in all material respects," is not used by the auditor when expressing an opinion on summarized financial statements.
25. **The auditor's report on summarized financial statements should include the following basic elements ordinarily in the following layout:**
 - (a) **Title² ;**
 - (b) **Addressee;**
 - (c) **An identification of the audited financial statements from which the summarized financial statements were derived;**

² See footnote 1.

- (d) **A reference to the date of the audit report on the unabridged financial statements and the type of opinion given in that report;**
- (e) **An opinion as to whether the information in the summarized financial statements is consistent with the audited financial statements from which it was derived. When the auditor has issued a modified opinion on the unabridged financial statements yet is satisfied with the presentation of the summarized financial statements, the audit report should state that, although consistent with the unabridged financial statements, the summarized financial statements were derived from financial statements on which a modified audit report was issued;**
- (f) **A statement, or reference to the note within the summarized financial statements, which indicates that for a better understanding of an entity's financial performance and position and of the scope of the audit performed, the summarized financial statements should be read in conjunction with the unabridged financial statements and the audit report thereon;**
- (g) **Date of the report;**
- (h) **Auditor's address; and**
- (i) **Auditor's signature.**

Appendix 4 to this ISA gives examples of auditor's reports on summarized financial statements.

Public Sector Perspective

1. *Some of the engagements considered "special purpose audit engagements" in the private sector are not special purpose in the public sector. For example, reports on financial statements prepared in accordance with a comprehensive basis of accounting other than IASs or national standards is ordinarily the norm, not the exception in the public sector. This has to be noted and guidance provided to the auditor on his or her responsibility to assess whether the accounting policies will result in misleading information.*
2. *A factor that also has to be considered is that public sector audit reports are ordinarily public documents and therefore, it is not possible to restrict the report to specific users.*

Appendix 1

Examples of Reports on Financial Statements Prepared in Accordance with a Comprehensive Basis of Accounting other than International Accounting Standards or National Standards

A Statement of Cash Receipts and Disbursements

AUDITOR'S REPORT TO

We have audited the accompanying statement of ABC Company's cash receipts and disbursements for the year ended December 31, 19X1³. This statement is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the accompanying statement based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company's policy is to prepare the accompanying statement on the cash receipts and disbursements basis. On this basis revenue is recognized when received rather than when earned, and expenses are recognized when paid rather than when incurred.

In our opinion, the accompanying statement gives a true and fair view of (or 'presents fairly, in all material respects,') the revenue collected and expenses paid by the Company during the year ended December 31, 19X1 in accordance with the cash receipts and disbursements basis as described in Note X.

Date

AUDITOR

Address

³ Provide suitable identification, such as by reference to page numbers or by identifying the individual statement.

Financial Statements Prepared on the Entity's Income Tax Basis

AUDITOR'S REPORT TO

We have audited the accompanying income tax basis financial statements of ABC Company for the year ended December 31, 19X1⁴. These statements are the responsibility of ABC Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 19X1 and its revenues and expenses for the year then ended, in accordance with the basis of accounting used for income tax purposes as described in Note X.

Date

AUDITOR

Address

⁴ See footnote 3.

Appendix 2

Examples of Reports on Components of Financial Statements

Schedule of Accounts Receivable

AUDITOR'S REPORT TO

We have audited the accompanying schedule of accounts receivable of ABC Company for the year ended December 31, 19X1⁵. This schedule is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the schedule based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the schedule. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of accounts receivable gives a true and fair view of (or 'presents fairly, in all material respects,') the accounts receivable of the Company as of December 31, 19X1 in accordance with ...⁶.

Date

AUDITOR

Address

⁵ See footnote 3.

⁶ Indicate the relevant national standards or refer to International Accounting Standards, the terms of an agreement or any described basis of accounting.

Schedule of Profit Participation

AUDITOR'S REPORT TO

We have audited the accompanying schedule of DEF's profit participation for the year ended December 31, 19X1⁷. This schedule is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the schedule based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the schedule. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of profit participation gives a true and fair view of (or 'presents fairly, in all material respects,') DEF's participation in the profits of the Company for the year ended December 31, 19X1 in accordance with the provisions of the employment agreement between DEF and the Company dated June 1, 19X0.

Date

AUDITOR

Address

⁷ See footnote 3.

Appendix 3

Examples of Reports on Compliance

Separate Report

AUDITOR'S REPORT TO

We have audited ABC Company's compliance with the accounting and financial reporting matters of sections XX to XX inclusive of the Indenture dated May 15, 19X1 with DEF Bank.

We conducted our audit in accordance with International Standards on Auditing applicable to compliance auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether ABC Company has complied with the relevant sections of the Indenture. An audit includes examining appropriate evidence on a test basis. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company was, in all material respects, in compliance with the accounting and financial reporting matters of the sections of the Indenture referred to in the preceding paragraphs as of December 31, 19X1.

Date

AUDITOR

Address

Report Accompanying Financial Statements

AUDITOR'S REPORT TO

We have audited the accompanying balance sheet of the ABC Company as of December 31, 19X1, and the related statements of income, and cash flows for the year then ended (the reference can be by page numbers). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We have also audited ABC Company's compliance with the accounting and financial reporting matters of sections XX to XX inclusive of the Indenture dated May 15, 19X1 with DEF Bank.

We conducted our audits in accordance with International Standards on Auditing (or refer to relevant national standards or practices) applicable to the audit of financial statements and to compliance auditing. Those Standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and about whether ABC Company has complied with the relevant sections of the Indenture. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion:

- (a) the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 19X1, and of the results of its operations and its cash flows for the year then ended in accordance with ... (and comply with ...); and
- (b) the Company was, in all material respects, in compliance with the accounting and financial reporting matters of the sections of the Indenture referred to in the preceding paragraphs as of December 31, 19X1.

Date

AUDITOR

Address

Appendix 4

Examples of Reports on Summarized Financial Statements

When an Unqualified Opinion Was Expressed on the Annual Audited Financial Statements

AUDITOR'S REPORT TO

We have audited the financial statements of ABC Company for the year ended December 31, 19X0, from which the summarized financial statements⁸ were derived, in accordance with International Standards on Auditing (or refer to relevant national standards or practices). In our report dated March 10, 19X1 we expressed an unqualified opinion on the financial statements from which the summarized financial statements were derived.

In our opinion, the accompanying summarized financial statements are consistent, in all material respects, with the financial statements from which they were derived.

For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon.

Date

AUDITOR

Address

⁸ See footnote 3.

When a Qualified Opinion Was Expressed on the Annual Audited Financial Statements

AUDITOR'S REPORT TO

We have audited the financial statements of ABC Company for the year ended December 31, 19X0, from which the summarized financial statements⁹ were derived, in accordance with International Standards on Auditing (or refer to relevant national standards or practices). In our report dated March 10, 19X1 we expressed an opinion that the financial statements from which the summarized financial statements were derived gave a true and fair view of (or 'presented fairly, in all material respects,') ... except that inventory had been overstated by

In our opinion, the accompanying summarized financial statements are consistent, in all material respects, with the financial statements from which they were derived and on which we expressed a qualified opinion.

For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon.

Date

AUDITOR

Address

⁹ See footnote 3.

INTERNATIONAL STANDARD ON AUDITING 810
THE EXAMINATION OF PROSPECTIVE
FINANCIAL INFORMATION

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. This ISA does not apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination.
2. **In an engagement to examine prospective financial information, the auditor should obtain sufficient appropriate evidence as to whether:**
 - (a) **Management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information;**
 - (b) **The prospective financial information is properly prepared on the basis of the assumptions;**
 - (c) **The prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and**
 - (d) **The prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles.**
3. "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection or a combination of both, for example, a one year forecast plus a five year projection.
4. A "forecast" means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).
5. A "projection" means prospective financial information prepared on the basis of:
 - (a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or

(b) A mixture of best-estimate and hypothetical assumptions.

Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a “what-if” scenario).

6. Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared:
 - (a) As an internal management tool, for example, to assist in evaluating a possible capital investment; or
 - (b) For distribution to third parties in, for example:
 - A prospectus to provide potential investors with information about future expectations.
 - An annual report to provide information to shareholders, regulatory bodies and other interested parties.
 - A document for the information of lenders which may include, for example, cash flow forecasts.
7. Management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the assumptions on which it is based. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility whether it is intended for use by third parties or for internal purposes.

The Auditor’s Assurance regarding Prospective Financial Information

8. Prospective financial information relates to events and actions that have not yet occurred and may not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the audit of historical financial information. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.
9. Further, given the types of evidence available in assessing the assumptions on which the prospective financial information is based, it may be difficult for the auditor to obtain a level of satisfaction sufficient to provide a positive expression of opinion that the assumptions are free of material misstatement. Consequently, in this ISA, when reporting on the reasonableness of management’s assumptions the auditor provides only a moderate level of assurance. However, when in the auditor’s judgment an appropriate level of satisfaction has been obtained, the auditor is not precluded from expressing positive assurance regarding the assumptions.

Acceptance of Engagement

10. Before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:
 - The intended use of the information.
 - Whether the information will be for general or limited distribution.
 - The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions.
 - The elements to be included in the information.
 - The period covered by the information.
11. **The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.**
12. **The auditor and the client should agree on the terms of the engagement.** It is in the interests of both entity and auditor that the auditor sends an engagement letter to help in avoiding misunderstandings regarding the engagement. An engagement letter would address the matters in paragraph 10 and set out management's responsibilities for the assumptions and for providing the auditor with all relevant information and source data used in developing the assumptions.

Knowledge of the Business

13. **The auditor should obtain a sufficient level of knowledge of the business to be able to evaluate whether all significant assumptions required for the preparation of the prospective financial information have been identified.** The auditor would also need to become familiar with the entity's process for preparing prospective financial information, for example, by considering:
 - The internal controls over the system used to prepare prospective financial information and the expertise and experience of those persons preparing the prospective financial information.
 - The nature of the documentation prepared by the entity supporting management's assumptions.
 - The extent to which statistical, mathematical and computer-assisted techniques are used.
 - The methods used to develop and apply assumptions.
 - The accuracy of prospective financial information prepared in prior periods and the reasons for significant variances.

14. **The auditor should consider the extent to which reliance on the entity's historical financial information is justified.** The auditor requires a knowledge of the entity's historical financial information to assess whether the prospective financial information has been prepared on a basis consistent with the historical financial information and to provide a historical yardstick for considering management's assumptions. The auditor will need to establish, for example, whether relevant historical information was audited or reviewed and whether acceptable accounting principles were used in its preparation.
15. If the audit or review report on prior period historical financial information was other than unmodified or if the entity is in a start-up phase, the auditor would consider the surrounding facts and the effect on the examination of the prospective financial information.

Period Covered

16. **The auditor should consider the period of time covered by the prospective financial information.** Since assumptions become more speculative as the length of the period covered increases, as that period lengthens, the ability of management to make best-estimate assumptions decreases. The period would not extend beyond the time for which management has a reasonable basis for the assumptions. The following are some of the factors that are relevant to the auditor's consideration of the period of time covered by the prospective financial information:
 - Operating cycle, for example, in the case of a major construction project the time required to complete the project may dictate the period covered.
 - The degree of reliability of assumptions, for example, if the entity is introducing a new product the prospective period covered could be short and broken into small segments, such as weeks or months. Alternatively, if the entity's sole business is owning a property under long-term lease, a relatively long prospective period might be reasonable.
 - The needs of users, for example, prospective financial information may be prepared in connection with an application for a loan for the period of time required to generate sufficient funds for repayment. Alternatively, the information may be prepared for investors in connection with the sale of debentures to illustrate the intended use of the proceeds in the subsequent period.

Examination Procedures

17. **When determining the nature, timing and extent of examination procedures, the auditor's considerations should include:**
 - (a) **The likelihood of material misstatement;**
 - (b) **The knowledge obtained during any previous engagements;**

- (c) **Management's competence regarding the preparation of prospective financial information;**
 - (d) **The extent to which the prospective financial information is affected by the management's judgment; and**
 - (e) **The adequacy and reliability of the underlying data.**
18. The auditor would assess the source and reliability of the evidence supporting management's best-estimate assumptions. Sufficient appropriate evidence supporting such assumptions would be obtained from internal and external sources including consideration of the assumptions in the light of historical information and an evaluation of whether they are based on plans that are within the entity's capacity.
 19. The auditor would consider whether, when hypothetical assumptions are used, all significant implications of such assumptions have been taken into consideration. For example, if sales are assumed to grow beyond the entity's current plant capacity, the prospective financial information will need to include the necessary investment in the additional plant capacity or the costs of alternative means of meeting the anticipated sales, such as subcontracting production.
 20. Although evidence supporting hypothetical assumptions need not be obtained, the auditor would need to be satisfied that they are consistent with the purpose of the prospective financial information and that there is no reason to believe they are clearly unrealistic.
 21. The auditor will need to be satisfied that the prospective financial information is properly prepared from management's assumptions by, for example, making clerical checks such as recomputation and reviewing internal consistency, that is, the actions management intends to take are compatible with each other and there are no inconsistencies in the determination of the amounts that are based on common variables such as interest rates.
 22. The auditor would focus on the extent to which those areas that are particularly sensitive to variation will have a material effect on the results shown in the prospective financial information. This will influence the extent to which the auditor will seek appropriate evidence. It will also influence the auditor's evaluation of the appropriateness and adequacy of disclosure.
 23. When engaged to examine one or more elements of prospective financial information, such as an individual financial statement, it is important that the auditor consider the interrelationship of other components in the financial statements.
 24. When any elapsed portion of the current period is included in the prospective financial information, the auditor would consider the extent to which procedures need to be applied to the historical information. Procedures will vary depending on the circumstances, for example, how much of the prospective period has elapsed.

25. **The auditor should obtain written representations from management regarding the intended use of the prospective financial information, the completeness of significant management assumptions and management's acceptance of its responsibility for the prospective financial information.**

Presentation and Disclosure

26. When assessing the presentation and disclosure of the prospective financial information, in addition to the specific requirements of any relevant statutes, regulations or professional standards, the auditor will need to consider whether:
 - (a) The presentation of prospective financial information is informative and not misleading;
 - (b) The accounting policies are clearly disclosed in the notes to the prospective financial information;
 - (c) The assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed;
 - (d) The date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;
 - (e) The basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and
 - (f) Any change in accounting policy since the most recent historical financial statements is disclosed, along with the reason for the change and its effect on the prospective financial information.

Report on Examination of Prospective Financial Information

27. **The report by an auditor on an examination of prospective financial information should contain the following:**
 - (a) **Title;**
 - (b) **Addressee;**
 - (c) **Identification of the prospective financial information;**

- (d) **A reference to the International Standards on Auditing or relevant national standards or practices applicable to the examination of prospective financial information;**
- (e) **A statement that management is responsible for the prospective financial information including the assumptions on which it is based;**
- (f) **When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;**
- (g) **A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;**
- (h) **An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;**
- (i) **Appropriate caveats concerning the achievability of the results indicated by the prospective financial information;**
- (j) **Date of the report which should be the date procedures have been completed;**
- (k) **Auditor's address; and**
- (l) **Signature.**

28. Such a report would:

- State whether, based on the examination of the evidence supporting the assumptions, anything has come to the auditor's attention which causes the auditor to believe that the assumptions do not provide a reasonable basis for the prospective financial information.
- Express an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.
- State that:
 - Actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range, and
 - In the case of a projection, the prospective financial information has been prepared for (state purpose), using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that the prospective financial information is not used for purposes other than that described.

29. The following is an example of an extract from an unmodified report on a forecast:

We have examined the forecast¹ in accordance with International Standards on Auditing applicable to the examination of prospective financial information. Management is responsible for the forecast including the assumptions set out in Note X on which it is based.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with²

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

30. The following is an example of an extract from an unmodified report on a projection:

We have examined the projection³ in accordance with International Standards on Auditing applicable to the examination of prospective financial information. Management is responsible for the projection including the assumptions set out in Note X on which it is based.

This projection has been prepared for (describe purpose). As the entity is in a start-up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that this projection may not be appropriate for purposes other than that described above.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that (state or refer to the hypothetical assumptions). Further, in our opinion the projection is properly prepared on the basis of the assumptions and is presented in accordance with⁴

Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

¹ Include name of the entity, the period covered by the forecast and provide suitable identification, such as by reference to page numbers or by identifying the individual statements.

² Indicate the relevant financial reporting framework.

³ Include name of the entity, the period covered by the projection and provide suitable identification, such as by reference to page numbers or by identifying the individual statements.

⁴ See footnote 2.

31. **When the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate.**
An example would be where financial information fails to disclose adequately the consequences of any assumptions which are highly sensitive.
32. **When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion in the report on the prospective financial information, or withdraw from the engagement.**
33. **When the examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances, the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.**

INTERNATIONAL STANDARD ON AUDITING 910
ENGAGEMENTS TO REVIEW FINANCIAL STATEMENTS
CONTENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's¹ professional responsibilities when an engagement to review financial statements is undertaken and on the form and content of the report that the auditor issues in connection with such a review.
2. This ISA is directed towards the review of financial statements. However, it is to be applied to the extent practicable to engagements to review financial or other information. This ISA is to be read in conjunction with ISA 120 "Framework of International Standards on Auditing." Guidance in other ISAs may be useful to the auditor in applying this ISA.

Objective of a Review Engagement

3. **The objective of a review of financial statements is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework (negative assurance).**

General Principles of a Review Engagement

4. **The auditor should comply with the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.** Ethical principles governing the auditor's professional responsibilities are:
 - (a) Independence;
 - (b) Integrity;
 - (c) Objectivity;
 - (d) Professional competence and due care;
 - (e) Confidentiality;
 - (f) Professional behavior; and
 - (g) Technical standards.
5. **The auditor should conduct a review in accordance with this ISA.**
6. **The auditor should plan and perform the review with an attitude of professional skepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated.**

¹ As explained in the Framework of International Standards on Auditing "... the term auditor is used throughout the ISAs when describing both auditing and related services which may be performed. Such reference is not intended to imply that a person performing related services need be the auditor of the entity's financial statements."

7. **For the purpose of expressing negative assurance in the review report, the auditor should obtain sufficient appropriate evidence primarily through inquiry and analytical procedures to be able to draw conclusions.**

Scope of a Review

8. The term “scope of a review” refers to the review procedures deemed necessary in the circumstances to achieve the objective of the review. **The procedures required to conduct a review of financial statements should be determined by the auditor having regard to the requirements of this ISA, relevant professional bodies, legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements.**

Moderate Assurance

9. A review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement, this is expressed in the form of negative assurance.

Terms of Engagement

10. **The auditor and the client should agree on the terms of the engagement.** The agreed terms would be recorded in an engagement letter or other suitable form such as a contract.
11. An engagement letter will be of assistance in planning the review work. It is in the interests of both the auditor and the client that the auditor send an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor’s acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor’s responsibilities and the form of reports to be issued.
12. Matters that would be included in the engagement letter include:
 - The objective of the service being performed.
 - Management’s responsibility for the financial statements.
 - The scope of the review, including reference to this International Standard on Auditing (or relevant national standards or practices).
 - Unrestricted access to whatever records, documentation and other information requested in connection with the review.
 - A sample of the report expected to be rendered.
 - The fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist.

- A statement that an audit is not being performed and that an audit opinion will not be expressed. To emphasize this point and to avoid confusion, the auditor may also consider pointing out that a review engagement will not satisfy any statutory or third party requirements for an audit.

An example of an engagement letter for a review of financial statements appears in Appendix 1 to this ISA.

Planning

13. **The auditor should plan the work so that an effective engagement will be performed.**
14. **In planning a review of financial statements, the auditor should obtain or update the knowledge of the business including consideration of the entity's organization, accounting systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses.**
15. The auditor needs to possess an understanding of such matters and other matters relevant to the financial statements, for example, a knowledge of the entity's production and distribution methods, product lines, operating locations and related parties. The auditor requires this understanding to be able to make relevant inquiries and to design appropriate procedures, as well as to assess the responses and other information obtained.

Work Performed by Others

16. **When using work performed by another auditor or an expert, the auditor should be satisfied that such work is adequate for the purposes of the review.**

Documentation

17. **The auditor should document matters which are important in providing evidence to support the review report, and evidence that the review was carried out in accordance with this ISA.**

Procedures and Evidence

18. **The auditor should apply judgment in determining the specific nature, timing and extent of review procedures.** The auditor will be guided by such matters as:
 - Any knowledge acquired by carrying out audits or reviews of the financial statements for prior periods.
 - The auditor's knowledge of the business including knowledge of the accounting principles and practices of the industry in which the entity operates.
 - The entity's accounting systems.

- The extent to which a particular item is affected by management judgment.
 - The materiality of transactions and account balances.
19. **The auditor should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were being given.** Although there is a greater risk that misstatements will not be detected in a review than in an audit, the judgment as to what is material is made by reference to the information on which the auditor is reporting and the needs of those relying on that information, not to the level of assurance provided.
20. Procedures for the review of financial statements will ordinarily include:
- Obtaining an understanding of the entity's business and the industry in which it operates.
 - Inquiries concerning the entity's accounting principles and practices.
 - Inquiries concerning the entity's procedures for recording, classifying and summarizing transactions, accumulating information for disclosure in the financial statements and preparing financial statements.
 - Inquiries concerning all material assertions in the financial statements.
 - Analytical procedures designed to identify relationships and individual items that appear unusual. Such procedures would include:
 - Comparison of the financial statements with statements for prior periods.
 - Comparison of the financial statements with anticipated results and financial position.
 - Study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience or industry norm.

In applying these procedures, the auditor would consider the types of matters that required accounting adjustments in prior periods.

- Inquiries concerning actions taken at meetings of shareholders, the board of directors, committees of the board of directors and other meetings that may affect the financial statements.
- Reading the financial statements to consider, on the basis of information coming to the auditor's attention, whether the financial statements appear to conform with the basis of accounting indicated.
- Obtaining reports from other auditors, if any and if considered necessary, who have been engaged to audit or review the financial statements of components of the entity.

- Inquiries of persons having responsibility for financial and accounting matters concerning, for example:
 - Whether all transactions have been recorded.
 - Whether the financial statements have been prepared in accordance with the basis of accounting indicated.
 - Changes in the entity's business activities and accounting principles and practices.
 - Matters as to which questions have arisen in the course of applying the foregoing procedures.
 - Obtaining written representations from management when considered appropriate.

Appendix 2 to this ISA provides an illustrative list of procedures which are often used. The list is not exhaustive, nor is it intended that all the procedures suggested apply to every review engagement.

21. **The auditor should inquire about events subsequent to the date of the financial statements that may require adjustment of or disclosure in the financial statements.** The auditor does not have any responsibility to perform procedures to identify events occurring after the date of the review report.
22. **If the auditor has reason to believe that the information subject to review may be materially misstated, the auditor should carry out additional or more extensive procedures as are necessary to be able to express negative assurance or to confirm that a modified report is required.**

Conclusions and Reporting

23. **The review report should contain a clear written expression of negative assurance. The auditor should review and assess the conclusions drawn from the evidence obtained as the basis for the expression of negative assurance.**
24. **Based on the work performed, the auditor should assess whether any information obtained during the review indicates that the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects,') in accordance with the identified financial reporting framework.**
25. The report on a review of financial statements describes the scope of the engagement to enable the reader to understand the nature of the work performed and make it clear that an audit was not performed and, therefore, that an audit opinion is not expressed.
26. **The report on a review of financial statements should contain the following basic elements, ordinarily in the following layout:**

- (a) **Title**²;
- (b) **Addressee**;
- (c) **Opening or introductory paragraph including:**
 - (i) **Identification of the financial statements on which the review has been performed; and**
 - (ii) **A statement of the responsibility of the entity's management and the responsibility of the auditor;**
- (d) **Scope paragraph, describing the nature of a review, including:**
 - (i) **A reference to this International Standard on Auditing applicable to review engagements, or to relevant national standards or practices;**
 - (ii) **A statement that a review is limited primarily to inquiries and analytical procedures; and**
 - (iii) **A statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit and that an audit opinion is not expressed;**
- (e) **Statement of negative assurance;**
- (f) **Date of the report;**
- (g) **Auditor's address; and**
- (h) **Auditor's signature.**

Appendices 3 and 4 to this ISA contain illustrations of review reports.

27. The review report should:

- (a) **State that nothing has come to the auditor's attention based on the review that causes the auditor to believe the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects,') in accordance with the identified financial reporting framework (negative assurance); or**
- (b) **If matters have come to the auditor's attention, describe those matters that impair a true and fair view ('or a fair presentation, in all material respects,') in accordance with the identified financial reporting framework, including, unless impracticable, a quantification of the possible effect(s) on the financial statements, and either:**
 - (i) **Express a qualification of the negative assurance provided; or**

² It may be appropriate to use the term "Independent" in the title to distinguish the auditor's report from reports that might be issued by others, such as officers of the entity, or from the reports of other auditors who may not have to abide by the same ethical requirements as an independent auditor.

- (ii) **When the effect of the matter is so material and pervasive to the financial statements that the auditor concludes that a qualification is not adequate to disclose the misleading or incomplete nature of the financial statements, give an adverse statement that the financial statements do not give a true and fair view (or ‘are not presented fairly, in all material respects,’) in accordance with the identified financial reporting framework; or**
 - (c) **If there has been a material scope limitation, describe the limitation and either:**
 - (i) **Express a qualification of the negative assurance provided regarding the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed; or**
 - (ii) **When the possible effect of the limitation is so significant and pervasive that the auditor concludes that no level of assurance can be provided, not provide any assurance.**
28. **The auditor should date the review report as of the date the review is completed, which includes performing procedures relating to events occurring up to the date of the report. However, since the auditor’s responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the review report earlier than the date on which the financial statements were approved by management.**

Appendix 1

Example of an Engagement Letter for a Review of Financial Statements

The following letter is for use as a guide in conjunction with the consideration outlined in paragraph 10 of this ISA and will need to be varied according to individual requirements and circumstances.

To the Board of Directors (or the appropriate representative of senior management):

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the balance sheet of ABC Company as of December 31, 19XX, and the related statements of income and cash flows for the year then ended, in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to reviews. We will not perform an audit of such financial statements and, accordingly, we will not express an audit opinion on them. Accordingly, we expect to report on the financial statements as follows:

(see Appendix 3 to this ISA)

Responsibility for the financial statements, including adequate disclosure, is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls and the selection and application of accounting policies. (As part of our review process, we will request written representations from management concerning assertions made in connection with the review³.)

This letter will be effective for future years unless it is terminated, amended or superseded (if applicable).

Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any material matters that come to our attention.

³ This sentence should be used at the discretion of the auditor.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our review of the financial statements.

XYZ & Co

Acknowledged on behalf of
ABC Company by

(signed)

.....

Name and Title

Date

Appendix 2

Illustrative Detailed Procedures that may be Performed in an Engagement to Review Financial Statements

1. The inquiry and analytical review procedures carried out in a review of financial statements are determined by the auditor's judgment. The procedures listed below are for illustrative purposes only. It is not intended that all the procedures suggested apply to every review engagement. This Appendix is not intended to serve as a program or checklist in the conduct of a review.

General

2. Discuss terms and scope of the engagement with the client and the engagement team.
3. Prepare an engagement letter setting forth the terms and scope of the engagement.
4. Obtain an understanding of the entity's business activities and the system for recording financial information and preparing financial statements.
5. Inquire whether all financial information is recorded:
 - (a) Completely;
 - (b) Promptly; and
 - (c) After the necessary authorization.
6. Obtain the trial balance and determine whether it agrees with the general ledger and the financial statements.
7. Consider the results of previous audits and review engagements, including accounting adjustments required.
8. Inquire whether there have been any significant changes in the entity from the previous year (*e.g.*, changes in ownership or changes in capital structure).
9. Inquire about the accounting policies and consider whether:
 - (a) They comply with local or international standards;
 - (b) They have been applied appropriately; and
 - (c) They have been applied consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.
10. Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.

11. Inquire if actions taken at shareholder, board of directors or comparable meetings that affect the financial statements have been appropriately reflected therein.
12. Inquire about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.
13. Inquire about contingencies and commitments.
14. Inquire about plans to dispose of major assets or business segments.
15. Obtain the financial statements and discuss them with management.
16. Consider the adequacy of disclosure in the financial statements and their suitability as to classification and presentation.
17. Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods and, if available, with budgets and forecasts.
18. Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.
19. Consider the effect of any unadjusted errors—individually and in aggregate. Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.
20. Consider obtaining a representation letter from management.

Cash

21. Obtain the bank reconciliations. Inquire about any old or unusual reconciling items with client personnel.
22. Inquire about transfers between cash accounts for the period before and after the review date.
23. Inquire whether there are any restrictions on cash accounts.

Receivables

24. Inquire about the accounting policies for initially recording trade receivables and determine whether any allowances are given on such transactions.
25. Obtain a schedule of receivables and determine whether the total agrees with the trial balance.
26. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.
27. Obtain an aged analysis of the trade receivables. Inquire about the reason for unusually large accounts, credit balances on accounts or any other unusual balances and inquire about the collectibility of receivables.

28. Discuss with management the classification of receivables, including noncurrent balances, net credit balances and amounts due from shareholders, directors and other related parties in the financial statements.
29. Inquire about the method for identifying “slow payment” accounts and setting allowances for doubtful accounts and consider it for reasonableness.
30. Inquire whether receivables have been pledged, factored or discounted.
31. Inquire about procedures applied to ensure that a proper cutoff of sales transactions and sales returns has been achieved.
32. Inquire whether accounts represent goods shipped on consignment and, if so, whether adjustments have been made to reverse these transactions and include the goods in inventory.
33. Inquire whether any large credits relating to revenue recorded have been issued after the balance sheet date and whether provision has been made for such amounts.

Inventories

34. Obtain the inventory list and determine whether:
 - (a) The total agrees with the balance in the trial balance; and
 - (b) The list is based on a physical count of inventory.
35. Inquire about the method for counting inventory.
36. Where a physical count was not carried out on the balance sheet date, inquire whether:
 - (a) A perpetual inventory system is used and whether periodic comparisons are made with actual quantities on hand; and
 - (b) An integrated cost system is used and whether it has produced reliable information in the past.
37. Discuss adjustments made resulting from the last physical inventory count.
38. Inquire about procedures applied to control cutoff and any inventory movements.
39. Inquire about the basis used in valuing each category of the inventory and, in particular, regarding the elimination of inter-branch profits. Inquire whether inventory is valued at the lower of cost and net realizable value.
40. Consider the consistency with which inventory valuation methods have been applied, including factors such as material, labor and overhead.
41. Compare amounts of major inventory categories with those of prior periods and with those anticipated for the current period. Inquire about major fluctuations and differences.

42. Compare inventory turnover with that in previous periods.
43. Inquire about the method used for identifying slow moving and obsolete inventory and whether such inventory has been accounted for at net realizable value.
44. Inquire whether any of the inventory has been consigned to the entity and, if so, whether adjustments have been made to exclude such goods from inventory.
45. Inquire whether any inventory is pledged, stored at other locations or on consignment to others and consider whether such transactions have been accounted for appropriately.

Investments (including associated companies and marketable securities)

46. Obtain a schedule of the investments at the balance sheet date and determine whether it agrees with the trial balance.
47. Inquire about the accounting policy applied to investments.
48. Inquire from management about the carrying values of investments. Consider whether there are any realization problems.
49. Consider whether there has been proper accounting for gains and losses and investment income.
50. Inquire about the classification of long-term and short-term investments.

Property and depreciation

51. Obtain a schedule of the property indicating the cost and accumulated depreciation and determine whether it agrees with the trial balance.
52. Inquire about the accounting policy applied regarding the provision for depreciation and distinguishing between capital and maintenance items. Consider whether the property has suffered a material, permanent impairment in value.
53. Discuss with management the additions and deletions to property accounts and accounting for gains and losses on sales or retirements. Inquire whether all such transactions have been accounted for.
54. Inquire about the consistency with which the depreciation method and rates have been applied and compare depreciation provisions with prior years.
55. Inquire whether there are any liens on the property.
56. Discuss whether lease agreements have been properly reflected in the financial statements in conformity with current accounting pronouncements.

Prepaid expenses, intangibles and other assets

57. Obtain schedules identifying the nature of these accounts and discuss with management the recoverability thereof.
58. Inquire about the basis for recording these accounts and the amortization methods used.
59. Compare balances of related expense accounts with those of prior periods and discuss significant variations with management.
60. Discuss the classification between long-term and short-term accounts with management.

Loans payable

61. Obtain from management a schedule of loans payable and determine whether the total agrees with the trial balance.
62. Inquire whether there are any loans where management has not complied with the provisions of the loan agreement and, if so, inquire as to management's actions and whether appropriate adjustments have been made in the financial statements.
63. Consider the reasonableness of interest expense in relation to loan balances.
64. Inquire whether loans payable are secured.
65. Inquire whether loans payable have been classified between noncurrent and current.

Trade payables

66. Inquire about the accounting policies for initially recording trade payables and whether the entity is entitled to any allowances given on such transactions.
67. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.
68. Obtain a schedule of trade payables and determine whether the total agrees with the trial balance.
69. Inquire whether balances are reconciled with the creditors' statements and compare with prior period balances. Compare turnover with prior periods.
70. Consider whether there could be material unrecorded liabilities.
71. Inquire whether payables to shareholders, directors and other related parties are separately disclosed.

Accrued and contingent liabilities

72. Obtain a schedule of the accrued liabilities and determine whether the total agrees with the trial balance.

73. Compare major balances of related expense accounts with similar accounts for prior periods.
74. Inquire about approvals for such accruals, terms of payment, compliance with terms, collateral and classification.
75. Inquire about the method for determining accrued liabilities.
76. Inquire as to the nature of amounts included in contingent liabilities and commitments.
77. Inquire whether any actual or contingent liabilities exist which have not been recorded in the accounts. If so, discuss with management whether provisions need to be made in the accounts or whether disclosure should be made in the notes to the financial statements.

Income and other taxes

78. Inquire from management if there were any events, including disputes with taxation authorities, which could have a significant effect on the taxes payable by the entity.
79. Consider the tax expense in relation to the entity's income for the period.
80. Inquire from management as to the adequacy of the recorded deferred and current tax liabilities including provisions in respect of prior periods.

Subsequent events

81. Obtain from management the latest interim financial statements and compare them with the financial statements being reviewed or with those for comparable periods from the preceding year.
82. Inquire about events after the balance sheet date that would have a material effect on the financial statements under review and, in particular, inquire whether:
 - (a) Any substantial commitments or uncertainties have arisen subsequent to the balance sheet date;
 - (b) Any significant changes in the share capital, long-term debt or working capital have occurred up to the date of inquiry; and
 - (c) Any unusual adjustments have been made during the period between the balance sheet date and the date of inquiry.

Consider the need for adjustments or disclosure in the financial statements.

83. Obtain and read the minutes of meetings of shareholders, directors and appropriate committees subsequent to the balance sheet date.

Litigation

84. Inquire from management whether the entity is the subject of any legal actions-threatened, pending or in process. Consider the effect thereof on the financial statements.

Equity

85. Obtain and consider a schedule of the transactions in the equity accounts, including new issues, retirements and dividends.
86. Inquire whether there are any restrictions on retained earnings or other equity accounts.

Operations

87. Compare results with those of prior periods and those expected for the current period. Discuss significant variations with management.
88. Discuss whether the recognition of major sales and expenses have taken place in the appropriate periods.
89. Consider extraordinary and unusual items.
90. Consider and discuss with management the relationship between related items in the revenue account and assess the reasonableness thereof in the context of similar relationships for prior periods and other information available to the auditor.

Appendix 3**Form of Unqualified Review Report**

REVIEW REPORT TO

We have reviewed the accompanying balance sheet of ABC Company at December 31, 19XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects,') in accordance with International Accounting Standards⁴.

Date

AUDITOR

Address

⁴ Or indicate the relevant national accounting standards.

Appendix 4**Examples of Review Reports other than Unqualified***Qualification For a Departure From International Accounting Standards*

REVIEW REPORT TO

We have reviewed the accompanying balance sheet of ABC Company at December 31, 19XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit, and, accordingly, we do not express an audit opinion.

Management has informed us that inventory has been stated at its cost which is in excess of its net realizable value. Management's computation, which we have reviewed, shows that inventory, if valued at the lower of cost and net realizable value as required by International Accounting Standards⁵, would have been decreased by \$X, and net income and shareholders' equity would have been decreased by \$Y.

Based on our review, except for the effects of the overstatement of inventory described in the previous paragraph, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects,') in accordance with International Accounting Standards.⁵

Date
Address

AUDITOR

⁵ See footnote 4.

Adverse Report For a Departure From International Accounting Standards

REVIEW REPORT TO

We have reviewed the balance sheet of ABC Company at December 31, 19XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

As noted in footnote X, these financial statements do not reflect the consolidation of the financial statements of subsidiary companies, the investment in which is accounted for on a cost basis. Under International Accounting Standards⁶, the financial statements of the subsidiaries are required to be consolidated.

Based on our review, because of the pervasive effect on the financial statements of the matter discussed in the preceding paragraph, the accompanying financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects,') in accordance with International Accounting Standards.⁶

Date
Address

AUDITOR

⁶ See footnote 4.

INTERNATIONAL STANDARD ON AUDITING 920
ENGAGEMENTS TO PERFORM AGREED-UPON
PROCEDURES REGARDING FINANCIAL INFORMATION

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's¹ professional responsibilities when an engagement to perform agreed-upon procedures regarding financial information is undertaken and on the form and content of the report that the auditor issues in connection with such an engagement.
2. This ISA is directed toward engagements regarding financial information. However, it may provide useful guidance for engagements regarding non-financial information, provided the auditor has adequate knowledge of the subject matter in question and reasonable criteria exist on which to base findings. This ISA is to be read in conjunction with ISA 120 "Framework of International Standards on Auditing." Guidance in other ISAs may be useful to the auditor in applying this ISA.
3. An engagement to perform agreed-upon procedures may involve the auditor in performing certain procedures concerning individual items of financial data (for example, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity), a financial statement (for example, a balance sheet) or even a complete set of financial statements.

Objective of an Agreed-upon Procedures Engagement

4. **The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.**
5. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.
6. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

General Principles of an Agreed-upon Procedures Engagement

7. **The auditor should comply with the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.** Ethical principles governing the auditor's professional responsibilities for this type of engagement are:

¹As explained in the Framework of International Standards on Auditing "... the term auditor is used throughout the ISAs when describing both auditing and related services which may be performed. Such reference is not intended to imply that a person performing related services need be the auditor of the entity's financial statements."

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality;
- (e) Professional behavior; and
- (f) Technical standards.

Independence is not a requirement for agreed-upon procedures engagements; however, the terms or objectives of an engagement or national standards may require the auditor to comply with the independence requirements of IFAC's Code of Ethics. Where the auditor is not independent, a statement to that effect would be made in the report of factual findings.

8. **The auditor should conduct an agreed-upon procedures engagement in accordance with this ISA and the terms of the engagement.**

Defining the Terms of the Engagement

9. **The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.** Matters to be agreed include the:
 - Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed.
 - Stated purpose for the engagement.
 - Identification of the financial information to which the agreed-upon procedures will be applied.
 - Nature, timing and extent of the specific procedures to be applied.
 - Anticipated form of the report of factual findings.
 - Limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.
10. In certain circumstances, for example, when the procedures have been agreed to between the regulator, industry representatives and representatives of the accounting profession, the auditor may not be able to discuss the procedures with all the parties who will receive the report. In such cases, the auditor may consider, for example, discussing the procedures to be applied with appropriate representatives of the parties involved, reviewing relevant correspondence from such parties or sending them a draft of the type of report that will be issued.

11. It is in the interests of both the client and the auditor that the auditor send an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of reports to be issued.
12. Matters that would be included in the engagement letter include:
 - A listing of the procedures to be performed as agreed upon between the parties.
 - A statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.

In addition, the auditor may consider attaching to the engagement letter a draft of the type of report of factual findings that will be issued. An example of an engagement letter appears in Appendix 1 to this ISA.

Planning

13. **The auditor should plan the work so that an effective engagement will be performed.**

Documentation

14. **The auditor should document matters which are important in providing evidence to support the report of factual findings, and evidence that the engagement was carried out in accordance with this ISA and the terms of the engagement.**

Procedures and Evidence

15. **The auditor should carry out the procedures agreed upon and use the evidence obtained as the basis for the report of factual findings.**
16. The procedures applied in an engagement to perform agreed-upon procedures may include:
 - Inquiry and analysis.
 - Recomputation, comparison and other clerical accuracy checks.
 - Observation.
 - Inspection.
 - Obtaining confirmations.

Appendix 2 to this ISA is an example report which contains an illustrative list of procedures which may be used as one part of a typical agreed-upon procedures engagement.

Reporting

17. The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed.
18. **The report of factual findings should contain:**
 - (a) **Title;**
 - (b) **Addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures);**
 - (c) **Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;**
 - (d) **A statement that the procedures performed were those agreed upon with the recipient;**
 - (e) **A statement that the engagement was performed in accordance with the International Standard on Auditing applicable to agreed-upon procedures engagements, or with relevant national standards or practices;**
 - (f) **When relevant a statement that the auditor is not independent of the entity;**
 - (g) **Identification of the purpose for which the agreed-upon procedures were performed;**
 - (h) **A listing of the specific procedures performed;**
 - (i) **A description of the auditor's factual findings including sufficient details of errors and exceptions found;**
 - (j) **Statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;**
 - (k) **A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;**
 - (l) **A statement that the report is restricted to those parties that have agreed to the procedures to be performed;**
 - (m) **A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;**
 - (n) **Date of the report;**
 - (o) **Auditor's address; and**

(p) Auditor's signature.

Appendix 2 to this ISA contains an example of a report of factual findings issued in connection with an engagement to perform agreed-upon procedures regarding financial information.

Public Sector Perspective

1. *The report in a public sector engagement may not be restricted only to those parties that have agreed to the procedures to be performed, but made available also to a wider range of entities or people (for example, a parliamentary investigation about a specific public entity or governmental department).*
2. *It also has to be noted that public sector mandates vary significantly and caution has to be taken to distinguish engagements that are truly "agreed upon procedures" from engagements that are expected to be audits of financial information, such as performance reports.*

Appendix 1

Example of an Engagement Letter for an Agreed-upon Procedures Engagement

The following letter is for use as a guide in conjunction with paragraph 9 of this ISA and is not intended to be a standard letter. The engagement letter will need to be varied according to individual requirements and circumstances.

Date

To the Board of Directors or other appropriate representatives of the client who engaged the auditor.

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services that we will provide. Our engagement will be conducted in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to agreed-upon procedures engagements and we will indicate so in our report.

We have agreed to perform the following procedures and report to you the factual findings resulting from our work:

(describe the nature, timing and extent of the procedures to be performed, including specific reference, where applicable, to the identity of documents and records to be read, individuals to be contacted and parties from whom confirmations will be obtained.)

The procedures that we will perform are solely to assist you in (state purpose). Our report is not to be used for any other purpose and is solely for your information.

The procedures that we will perform will not constitute an audit or a review made in accordance with International Standards on Auditing (or refer to relevant national standards or practices) and, consequently, no assurance will be expressed.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information requested in connection with our engagement.

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

ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the terms of the engagement including the specific procedures which we have agreed will be performed.

XYZ & Co

Acknowledged on behalf of
ABC Company by

(signed)

.....

Name and Title

Date

Appendix 2

Example of a Report of Factual Findings in Connection with Accounts Payable

REPORT OF FACTUAL FINDINGS

To (those who engaged the auditor)

We have performed the procedures agreed with you and enumerated below with respect to the accounts payable of ABC Company as at (date), set forth in the accompanying schedules (not shown in this example). Our engagement was undertaken in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarized as follows:

1. We obtained and checked the addition of the trial balance of accounts payable as at (date) prepared by ABC Company, and we compared the total to the balance in the related general ledger account.
2. We compared the attached list (not shown in this example) of major suppliers and the amounts owing at (date) to the related names and amounts in the trial balance.
3. We obtained suppliers' statements or requested suppliers to confirm balances owing at (date).
4. We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and outstanding checks, each of which was greater than \$xxx. We located and examined such invoices and credit notes subsequently received and checks subsequently paid and we ascertained that they should in fact have been listed as outstanding on the reconciliations.

We report our findings below:

- (a) With respect to item 1 we found the addition to be correct and the total amount to be in agreement.
- (b) With respect to item 2 we found the amounts compared to be in agreement.
- (c) With respect to item 3 we found there were suppliers' statements for all such suppliers.
- (d) With respect to item 4 we found the amounts agreed, or with respect to amounts which did not agree, we found ABC Company had prepared

ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES

reconciliations and that the credit notes, invoices and outstanding checks over \$xxx were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)

Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing (or relevant national standards or practices), we do not express any assurance on the accounts payable as of (date).

Had we performed additional procedures or had we performed an audit or review of the financial statements in accordance with International Standards on Auditing (or relevant national standards or practices), other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of ABC Company, taken as a whole.

Date

AUDITOR

Address

INTERNATIONAL STANDARD ON AUDITING 930

ENGAGEMENTS TO COMPILE FINANCIAL STATEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the accountant's¹ professional responsibilities when an engagement to compile financial information is undertaken and the form and content of the report the accountant issues in connection with such a compilation.
2. This ISA is directed toward the compilation of financial information. However, it is to be applied to the extent practicable to engagements to compile non-financial information, provided the accountant has adequate knowledge of the subject matter in question. Engagements to provide limited assistance to a client in the preparation of financial statements (for example, on the selection of an appropriate accounting policy), do not constitute an engagement to compile financial information. This ISA is to be read in conjunction with ISA 120 "Framework of International Standards on Auditing."

Objective of a Compilation Engagement

3. **The objective of a compilation engagement is for the accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarize financial information.** This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the accountant to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the accountant's involvement because the service has been performed with professional competence and due care.
4. A compilation engagement would ordinarily include the preparation of financial statements (which may or may not be a complete set of financial statements) but may also include the collection, classification and summarization of other financial information.

General Principles of a Compilation Engagement

5. **The accountant should comply with the "Code of Ethics for Professional Accountants" issued by IFAC.** Ethical principles governing the accountant's professional responsibilities for this type of engagement are:
 - (a) Integrity;
 - (b) Objectivity;

¹ For the purposes of this ISA and to distinguish between an audit and a compilation engagement the term 'accountant' (rather than 'auditor') has been used throughout to refer to a professional accountant in public practice.

- (c) Professional competence and due care;
- (d) Confidentiality;
- (e) Professional behavior; and
- (f) Technical standards.

Independence is not a requirement for a compilation engagement. However, where the accountant is not independent, a statement to that effect would be made in the accountant's report.

6. **In all circumstances when an accountant's name is associated with financial information compiled by the accountant, the accountant should issue a report.**

Defining the Terms of the Engagement

7. **The accountant should ensure that there is a clear understanding between the client and the accountant regarding the terms of the engagement.** Matters to be considered include the:
 - Nature of the engagement including the fact that neither an audit nor a review will be carried out and that accordingly no assurance will be expressed.
 - Fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist.
 - Nature of the information to be supplied by the client.
 - Fact that management is responsible for the accuracy and completeness of the information supplied to the accountant for the completeness and accuracy of the compiled financial information.
 - Basis of accounting on which the financial information is to be compiled and the fact that it, and any known departures therefrom, will be disclosed.
 - Intended use and distribution of the information, once compiled.
 - Form of report to be rendered regarding the financial information compiled, when the accountant's name is to be associated therewith.
8. An engagement letter will be of assistance in planning the compilation work. It is in the interests of both the accountant and the entity that the accountant send an engagement letter documenting the key terms of the appointment. An engagement letter confirms the accountant's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the accountant's responsibilities and the form of reports to be issued. An example of an engagement letter for a compilation engagement appears in Appendix 1 to this ISA.

Planning

9. **The accountant should plan the work so that an effective engagement will be performed.**

Documentation

10. **The accountant should document matters which are important in providing evidence that the engagement was carried out in accordance with this ISA and the terms of the engagement.**

Procedures

11. **The accountant should obtain a general knowledge of the business and operations of the entity and should be familiar with the accounting principles and practices of the industry in which the entity operates and with the form and content of the financial information that is appropriate in the circumstances.**
12. To compile financial information, the accountant requires a general understanding of the nature of the entity's business transactions, the form of its accounting records and the accounting basis on which the financial information is to be presented. The accountant ordinarily obtains knowledge of these matters through experience with the entity or inquiry of the entity's personnel.
13. Other than as noted in this ISA, the accountant is not ordinarily required to:
 - (a) Make any inquiries of management to assess the reliability and completeness of the information provided;
 - (b) Assess internal controls;
 - (c) Verify any matters; or
 - (d) Verify any explanations.
14. **If the accountant becomes aware that information supplied by management is incorrect, incomplete, or otherwise unsatisfactory, the accountant should consider performing the above procedures and request management to provide additional information. If management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for the withdrawal.**
15. **The accountant should read the compiled information and consider whether it appears to be appropriate in form and free from obvious material misstatements.** In this sense, misstatements include:
 - Mistakes in the application of the identified financial reporting framework.

- Nondisclosure of the financial reporting framework and any known departures therefrom.
- Nondisclosure of any other significant matters of which the accountant has become aware.

The identified financial reporting framework and any known departures there from should be disclosed within the financial information, though their effects need not be quantified.

16. **If the accountant becomes aware of material misstatements, the accountant should try to agree appropriate amendments with the entity. If such amendments are not made and the financial information is considered to be misleading, the accountant should withdraw from the engagement.**

Responsibility of Management

17. **The accountant should obtain an acknowledgment from management of its responsibility for the appropriate presentation of the financial information and of its approval of the financial information.** Such acknowledgment may be provided by representations from management which cover the accuracy and completeness of the underlying accounting data and the complete disclosure of all material and relevant information to the accountant.

Reporting on a Compilation Engagement

18. **Reports on compilation engagements should contain² the following:**
 - (a) **Title;**
 - (b) **Addressee;**
 - (c) **A statement that the engagement was performed in accordance with the ISA applicable to compilation engagements, or with national standards and practices;**
 - (d) **When relevant, a statement that the accountant is not independent of the entity;**
 - (e) **Identification of the financial information noting that it is based on information provided by management;**
 - (f) **A statement that management is responsible for the financial information compiled by the accountant;**

² It may also be appropriate for the accountant to refer to the special purpose for which or party for whom the information has been prepared. Alternatively, or in addition, the accountant may add some form of caution designed to ensure that it is not used for purposes other than those intended.

- (g) **A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;**
- (h) **A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;**
- (i) **Date of the report;**
- (j) **Accountant's address; and**
- (k) **Accountant's signature.**

Appendix 2 to this ISA contains examples of compilation reports.

19. **The financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" or "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.**

Appendix 1

Example of an Engagement Letter for a Compilation Engagement

The following letter is for use as a guide in conjunction with the considerations outlined in paragraph 7 of this ISA and will need to be varied according to individual requirements and circumstances. This example is for the compilation of financial statements.

(Date)

To the Board of Directors or the appropriate representatives of senior management:

This letter is to confirm our understanding of the terms of our engagement and the nature and limitations of the services we will provide.

You have requested that we perform the following services:

On the basis of information you provide, we will compile, in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to compilation engagements, the balance sheet of ABC Company as of December 31, 19XX and related statements of income and cash flows for the year then ended on a cash basis. We will not carry out audit or review engagement procedures in relation to such financial statements. Consequently, no assurance on the financial statements will be expressed. Our report on the financial statements of ABC Company is presently expected to read as follows:

(see Appendix 2 to this ISA)

Management is responsible for both the accuracy and completeness of the information supplied to us and is responsible to users for the financial information compiled by us. This includes the maintenance of adequate accounting records and internal controls and the selection and application of appropriate accounting policies. Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any such matters which come to our attention.

The information will be prepared in accordance with [identified financial reporting framework]. Any known departures from this framework will be disclosed within the financial statements and when considered necessary will be referred to in our compilation report.

We understand that the intended use and distribution of the information we have compiled is [specify] and that should this change in a material respect, that you will inform us.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information requested in connection with our compilation.

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly

rates vary according to the degree of responsibility involved and the experience and skill required.

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

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our compilation of your financial statements.

XYZ & Co

Acknowledged on behalf of
ABC Company by

(signed)

.....

Name and Title

Date

Appendix 2

Examples of Compilation Reports

Example of a Report on an Engagement to Compile Financial Statements

COMPILATION REPORT TO

On the basis of information provided by management we have compiled, in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to compilation engagements, the balance sheet of ABC Company as of December 31, 19XX and statements of income and cash flows for the year then ended. Management is responsible for these financial statements. We have not audited or reviewed these financial statements and accordingly express no assurance thereon³.

Date

ACCOUNTANT

Address

³ See footnote 2.

Example of a Report on an Engagement to Compile Financial Statements with an Additional Paragraph that Draws Attention to a Departure from the Identified Financial Reporting Framework

COMPILATION REPORT TO

On the basis of information provided by management we have compiled, in accordance with the International Standard on Auditing (or refer to relevant national standards or practices) applicable to compilation engagements, the balance sheet of XYZ Company as of December 31, 19XX and the related statements of income and cash flows for the year then ended. Management is responsible for these financial statements. We have not audited or reviewed these financial statements and accordingly express no assurance thereon⁴.

We draw attention to Note X to the financial statements because management has elected not to capitalize the leases on plant and machinery which is a departure from the identified financial reporting framework.

Date

ACCOUNTANT

Address

⁴ See footnote 2.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1000

INTER-BANK CONFIRMATION PROCEDURES

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This International Auditing Practice Statement was prepared and approved jointly by the International Auditing Practices Committee of the International Federation of Accountants and the Committee on Banking Regulations and Supervisory Practices of the Group of Ten major industrialized countries and Switzerland in November 1983 for publication in February 1984.

This Statement is published to provide practical assistance to external independent auditors and also internal auditors and inspectors on inter-bank confirmation procedures. This statement is not intended to have the authority of an International Standard on Auditing.

Introduction

1. The purpose of this Statement is to provide assistance on inter-bank confirmation procedures to the external independent auditor and also to bank management, such as internal auditors or inspectors. The guidance contained in this Statement should contribute to the effectiveness of inter-bank confirmation procedures and to the efficiency of processing replies.
2. An important audit step in the examination of bank financial statements and related information is to request direct confirmation from other banks of both balances and other amounts which appear in the balance sheet and other information which may not be shown on the face of the balance sheet but which may be disclosed in the notes to the accounts. Off balance sheet items requiring confirmation include, such items as guarantees, forward purchase and sale commitments, repurchase options, and offset arrangements. This type of audit evidence is valuable because it comes directly from an independent source and, therefore, provides greater assurance of reliability than that obtained solely from the bank's own records.
3. The auditor, in seeking to obtain inter-bank confirmations, may encounter difficulties in relation to language, terminology, consistent interpretation and scope of matters covered by the reply. Frequently, these difficulties result from the use of different kinds of confirmation requests or misunderstandings about what they are intended to cover.
4. Audit procedures may differ from country to country, and consequently local practices will have relevance to the way in which inter-bank confirmation procedures are applied. While this Statement does not purport to describe a comprehensive set of audit procedures, nevertheless, it does emphasize some important steps which should be followed in the use of a confirmation request.

The Need for Confirmation

5. An essential feature of management control over business relations, with individuals or groups of financial institutions, is the ability to obtain confirmation of transactions with those institutions and of the resulting positions. The requirement for bank confirmation arises from the need of the bank's management and its auditors to confirm the financial and business relationships between the following:
 - The bank and other banks within the same country;
 - The bank and other banks in different countries; and
 - The bank and its non-bank customers.

While inter-bank relationships are similar in nature to those between the bank and a non-bank customer, there may be special significance in some inter-bank relationships, for example, in connection with certain types of "off balance

sheet” transactions, such as contingencies, forward transactions, commitments and offset agreements.

Use of Confirmation Requests

6. The guidance set out in the following paragraphs is designed to assist banks and their auditors to obtain independent confirmation of financial and business relationships within other banks. However, there may be occasions on which the approach described within this Statement may also be appropriate to confirmation procedures between the bank and its non-bank customers. The procedures described are not relevant to the routine inter-bank confirmation procedures which are carried out in respect to the day to day commercial transactions conducted between banks.
7. The auditor should decide from which bank or banks to request confirmation, have regard to such matters as size of balances, volume of activity, degree of reliance on internal controls, and materiality within the context of the financial statements. Tests of particular activities of the bank may be structured in different ways and confirmation requests may, therefore, be limited solely to inquiries about those activities. Requests for confirmation of individual transactions may either form part of the test of a bank’s system of internal control or be a means of verifying balances appearing in a bank’s financial statements at a particular date. Therefore, confirmation requests should be designed to meet the particular purpose for which they are required.
8. The auditor should determine which of the following approaches is the most appropriate in seeking confirmation of balances or other information from another bank:
 - Listing balances and other information, and requesting confirmation of their accuracy and completeness, or
 - Requesting details of balances and other information, which can then be compared with the requesting bank’s records.

In determining which of the above approaches is the most appropriate, the auditor should weigh the quality of audit evidence he requires in the particular circumstances against the practicality of obtaining a reply from the confirming bank.

9. Difficulty may be encountered in obtaining a satisfactory response even where the requesting bank submits information for confirmation to the confirming bank. It is important that a response be sought for all confirmation requests. It is not usual practice to request a response only if the information submitted is incorrect or incomplete.

Preparation and Dispatch of Requests and Receipt of Replies

10. The auditor should determine the appropriate location to which the confirmation request should be sent, for example a department, such as

internal audit, inspection and other specialist department, which may be designated by the confirming bank as responsible for replying to confirmation requests. It may be appropriate, therefore, to direct confirmation requests to the head office of the bank (in which such departments are often located) rather than to the location where balances and other relevant information are held. In other situations, the appropriate location may be the local branch of the confirming bank.

11. Whenever possible, the confirmation request should be prepared in the language of the confirming bank or in the language normally used for business purposes.
12. Control over the content and dispatch of confirmation requests is the responsibility of the auditor. However, it will be necessary for the request to be authorized by the requesting bank. Replies should be returned directly to the auditor and to facilitate such a reply, a pre-addressed envelope should be enclosed with the request.

Content of Confirmation Requests

13. The form and content of a confirmation request letter will depend on the purpose for which it is required, on local practices and on the requesting bank's account procedures, for example, whether or not it makes extensive use of electronic data processing.
14. The confirmation request should be prepared in a clear and concise manner to ensure ready comprehension by the confirming bank.
15. Not all information for which confirmation is usually sought will be required at the same time. Accordingly, request letters may be sent at various times during the year dealing with particular aspects of the inter-bank relationship.
16. The most commonly requested information is in respect of balances due to or from the requesting bank on current, deposit, loan and other accounts. The request letter should provide the account description, number and the type of currency for the account. It may also be advisable to request information about nil balances on correspondent accounts, and correspondent accounts which were closed in the twelve months prior to the chosen confirmation date. The requesting bank may ask for confirmation not only of the balances on accounts but also, where it may be helpful, other information, such as the maturity and interest terms, unused facilities, lines of credit/standby facilities, any offset or other rights or encumbrances, and details of any collateral given or received.
17. An important part of banking business relates to the control of those transactions commonly designated as "off balance sheet." Accordingly, the requesting bank and its auditors are likely to request confirmation of contingent liabilities, such as those arising on guarantees, comfort letters and letters of undertaking, bills, own acceptances, and endorsements. Confirmation may be sought both of the contingent liabilities of the requesting bank to the confirming bank and of the confirming bank to the requesting bank. The

details supplied or requested should describe the nature of the contingent liabilities together with their currency and amount.

18. Confirmation of asset repurchase and resale agreements and options outstanding at the relevant date should also be sought. Such confirmation should describe the asset covered by the agreement, the date the transaction was contracted, its maturity date, and the terms on which it was completed.
19. Another category of information, for which independent confirmation is often requested at a date other than the transaction date, concerns forward currency, bullion, securities and other outstanding contracts. It is well established practice for banks to confirm transactions with other banks as they are made. However, it is the practice for audit purposes to confirm independently a sample of transactions selected from a period of time or to confirm all the unmatured transactions with a counterparty. The request should give details of each contract including its number, the deal date, the maturity or value date, the price at which the deal was transacted and the currency and amount of the contract bought and sold, to and from, the requesting bank.
20. Banks often hold securities and other items in safe custody on behalf of customers. A request letter may thus ask for confirmation of such items held by the confirming bank, at a specific date. The confirmation should include a description of the items and the nature of any encumbrances or other rights over them.

Appendix

Glossary

This Appendix defines certain terms used in this Statement. The list is not intended to include all terms used in an inter-bank confirmation request. Definitions have been given within a banking context, although usage and legal application may differ.

Collateral

Security given by a borrower to a lender as a pledge for repayment of a loan, rarely given in the case of inter-bank business. Such lenders thus become secured creditors; in the event of default, such creditors are entitled to proceed against collateral in settlement of their claim. Any kind of property may be employed as collateral. Examples of collateral are: real estate, bonds, stocks, notes, acceptances, chattels, bills of lading, warehouse receipts and assigned debts.

Contingent Liabilities

Potential liabilities, which only crystallize upon the fulfillment of or the failure to fulfill certain conditions. They may arise from the sale, transfer, endorsement, or guarantee of negotiable instruments or from other financial transactions. For example, they may result from:

- Re-discount of notes receivable, trade and bank acceptances arising under commercial letters of credit;
- Guarantees given; or
- Letters of support or comfort.

Encumbrance

A claim or lien, such as a mortgage upon real property, which diminishes the owner's equity in the property.

Offset

The right of a bank, normally evidenced in writing, to take possession of any account balances that a guarantor or debtor may have with it to cover the obligations to the bank of the guarantor, debtor or third party.

Options

The right to buy or sell or to both buy and sell securities or commodities at agreed prices, within a fixed duration of time.

Repurchase (or Resale) Agreement

An agreement between seller and buyer that the seller (or buyer) will buy (or sell) back notes, securities, or both property at the expiration of a period of time, or the completion of certain conditions, or both.

Safe Custody

A facility offered by banks to their customers to store valuable property for safe keeping.

Line of Credit/Standby Facility

An agreed maximum amount of funds which a bank has made or undertakes to make available over a specified period of time.

**INTERNATIONAL AUDITING
PRACTICE STATEMENT 1001
IT ENVIRONMENTS—STAND-ALONE COMPUTERS
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The International Auditing Practices Committee (“IAPC”) of the International Federation of Accountants issues International Auditing Practices Statements (“Statements”) to provide practical assistance to auditors in implementing the International Standards on Auditing (“ISAs”) or to promote good practice. Statements do not have the authority of ISAs.

This Statement does not establish any new basic principles or essential procedures; its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of the ISAs when stand-alone PCs are used in the production of information that is material to the financial statements of the entity. The auditor exercises professional judgment to determine the extent to which any of the audit procedures described in this Statement may be appropriate in the light of the requirements of the ISAs and the entity’s particular circumstances.

The auditor understands and considers the characteristics of an IT environment because they affect the design of the accounting system and related internal controls. Accordingly, an IT environment may affect the overall audit plan including the selection of internal controls the auditor intends to rely on and the nature, timing and extent of audit procedures.

The IAPC approved this International Auditing Practice Statement in June 2001 for publication in July 2001.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where there is no PSP, the IAPS applies in all material respects to the public sector.

Introduction

1. This Statement describes the effects of stand-alone PCs on the accounting system and related internal controls and on audit procedures.

Stand-Alone PCs

2. PCs can be used to process accounting transactions and produce reports that are essential to the preparation of financial statements. The PC may constitute the entire computer-based accounting system or merely a part of it.
3. Generally, information technology (IT) environments in which stand-alone PCs are used are somewhat different from other IT environments. Certain controls and security measures that are used for large computer systems may not be practicable for PCs. In contrast, certain types of internal controls become more important because of the characteristics of stand-alone PCs and the environments in which they are used.
4. Stand-alone PCs can be operated by a single user or many users at different times accessing the same or different programs on the same computer. The user of a stand-alone PC that processes accounting applications performs many functions (for example, entering data and operating application programs). While typically not knowledgeable about programming, users may often use third-party or off-the-shelf software packages such as electronic spreadsheets or database applications.
5. The organizational structure within which a stand-alone PC is used is important in assessing risks and the extent of the controls required to mitigate those risks. For example monitoring controls employed by management may be the only effective controls for a purchased software package used by a small business on a stand-alone PC apart from whatever controls are incorporated in the package itself. In contrast, the effectiveness of controls relating to a stand-alone PC used within a larger organization may depend on an organizational structure that clearly segregates responsibilities and restricts the use of the stand-alone PC to specific functions.
6. The control considerations and the characteristics of the hardware and software are different when a PC is linked to other computers. Such situations often lead to increased risks. This Statement does not address the auditor's consideration of network security and controls. This Statement is however relevant for PCs that are linked to another computer, but can also be used as stand-alone workstations. Many PCs may be used interchangeably as part of a network or in stand-alone mode. When dealing with such PCs, the auditor considers the additional risks encountered by access through a network as well as the guidance in this Statement.

Internal Control in Stand-Alone PC Environments

7. PCs are oriented to individual end-users. The degree of accuracy and reliability of financial information they produce will depend, in part, on the internal controls that the user adopts either voluntarily or because management has prescribed them. The control procedures implemented relate to the complexity of the business environment in which the PC operates. Ordinarily, the stand-alone PC environment is less structured than a centrally controlled IT environment. In the former, users with only basic data processing skills can implement application programs relatively quickly, triggering issues such as the adequacy of systems' documentation or access control procedures. Such users may not regard controls over the application implementation process (for example, adequate documentation) and operations (for example, access control procedures) as important or cost-effective. In such circumstances, because the financial information is processed on a computer, users may tend to place unwarranted reliance on it.
8. In a typical stand-alone PC environment, the level of general controls is lower than what would be found in a large-scale computing environment. Nevertheless, selected security and control procedures can help improve the overall level of internal control.

Organizational Policies and Procedures

9. As part of the acquisition of an understanding of the control environment, and hence the IT environment for stand-alone PCs, the auditor considers the organizational structure of the entity and, in particular, the allocation of responsibilities for data processing. Effective policies and procedures for the acquisition, implementation, operation and maintenance of stand-alone PCs can enhance the overall control environment. A failure to implement such policies may lead to the entity using out of date programs and to errors in the data and the information derived from them, and may lead to an increased risk of fraud. Such policies and procedures include the following:
 - Acquisition, implementation and documentation standards;
 - User training;
 - Security, back-up and storage guidelines;
 - Password management;
 - Personal usage policies;
 - Software acquisition and usage standards;
 - Data protection standards;
 - Program maintenance and technical support;
 - An appropriate level of segregation of duties and responsibilities; and

- Virus protection.

Physical Protection—Equipment

10. Because of their physical characteristics, stand-alone PCs and their storage media are susceptible to theft, physical damage, unauthorized access or misuse. They can be physically protected by:
 - Locking them in a protective room, cabinet or shell;
 - Using an alarm system that is activated if the PC is disconnected or moved from its location;
 - Fastening the PC to a table;
 - Policies outlining the proper procedures to follow when traveling with a laptop or using it off premises;
 - Encryption of key files;
 - Installing a locking mechanism to control access to the on/off switch. This may not prevent PC theft, but may be effective in controlling unauthorized use; and
 - Implementing environmental controls to prevent damages from natural disasters, such as fire, floods, etc.

Physical Protection—Removable and Non-Removable Media

11. PC programs and data can be stored on removable or non-removable storage media. For example, diskettes and CDs can be removed physically from the stand-alone PC, while hard disks are normally contained in the PC or in a stand-alone unit attached to it. In addition, the interior components (including the hard drive) of many PCs, in particular laptops, are easily accessible. When many individuals use a particular PC, storage media are more likely to be misplaced, altered without authorization or destroyed.
12. It is the user's responsibility to protect removable storage media by, for example, keeping current backups of such media in a fireproof container, either on site, off site, or both. This applies equally to operating systems, application programs and data.

Program and Data Security

13. When PCs are accessible to many users, there is a risk that the operating system, programs and data may be altered without authorization, or that users may install their own versions of programs giving rise to potential software licensing liabilities.
14. The degree of control and security features present in a PC operating system vary. Although some operating systems contain sophisticated built-in security features, those used on stand-alone PCs generally do not. Nevertheless, there

are techniques to help ensure data are processed and read as authorized and that accidental destruction of data is minimized. The following techniques can limit access to programs and data to authorized personnel:

- Using passwords;
 - Implementing an access control package;
 - Using of removable storage media;
 - Using hidden directories and files; and
 - Using encryption.
15. An effective control technique is to use profiles and passwords, which control the level of access granted to a user. For example, a user may be given a profile protected by a password that allows data entry only, and a stand-alone PC might be configured to require a password before it can be “booted-up.”
 16. In some instances an access control package can provide effective control over the access to and use of operating systems, programs and data. For example, only a specific user may have access to the password file or be allowed to install programs. Such packages can also regularly examine programs on the PC to detect whether unauthorized programs or versions of programs are being used.
 17. The use of removable storage media for critical and sensitive programs and data can provide enhanced protection by being kept off-line and under independent control until required. For example, salary data in a payroll system may be kept off-line and used only when required for payroll processing.
 18. Removing programs and data from PCs with removable storage media (for example, diskettes, CDs and cartridges) is one effective way to keep them secure. The media are then placed in the custody of the file librarians or the users responsible for the data or programs.
 19. Encryption is a technique that is generally used when sensitive data are transmitted over communication lines, but it can also be used on data stored on a stand-alone PC.

Continuity of Operations

20. In a PC environment, management typically relies on the user to ensure the continued availability of the systems in the event of a failure, loss or destruction of the equipment, operating system, programs or data. This will entail:
 - (a) The user retaining copies of the operating systems, programs and data, with at least one copy stored at a secure location away from the PC; and
 - (b) Access being available to alternative equipment within a reasonable time given the use and importance of the underlying system.

The Effect of Stand-Alone PCs on the Accounting System and Related Internal Controls

21. The effect of PCs on the accounting system and the associated risks will generally depend on:
 - (a) The extent to which the PC is being used to process accounting applications;
 - (b) The type and significance of financial transactions being processed; and
 - (c) The nature of programs and data used in the applications.
22. Below is a summary of some of the key considerations and their effects on both general and application controls.

General Controls—Segregation of Duties

23. In a PC environment, users can generally perform two or more of the following functions in the accounting system:
 - (a) Initiating source documents;
 - (b) Authorizing source documents;
 - (c) Entering data into the system;
 - (d) Processing data that have been entered;
 - (e) Changing programs and data;
 - (f) Using or distributing output; and
 - (g) Modifying the operating systems.
24. In other IT environments, such functions would generally be segregated through appropriate general controls. This lack of segregation of functions in a PC environment may allow errors to go undetected and permit the perpetration and concealment of fraud.

Application Controls

25. The existence and use of appropriate access controls over programs and data, combined with controls over input, processing and output of data may, in coordination with management policies, compensate for some of the weaknesses in general controls in PC environments. Effective controls include the following:
 - Programmed control procedures, such as limit checks;
 - A system of transaction logs and batch balancing, including follow up and resolution of any exceptions;
 - Direct supervision, for example, a review of reports; and

- A reconciliation of record counts or hash totals.
26. Control may be established by an independent function that generally:
- (a) Receives all data for processing;
 - (b) Ensures that all data are authorized and recorded;
 - (c) Follows up all errors detected during processing;
 - (d) Verifies the proper distribution of output; and
 - (e) Restricts physical access to application programs and data.
- Separate controls are ordinarily required over master file and transaction data.

The Effect of a Stand-Alone PC Environment on Audit Procedures

27. In a stand-alone PC environment, it may not be practicable or cost-effective for management to implement sufficient controls to reduce the risks of undetected errors to a minimum level. In this situation, after obtaining the understanding of the accounting system and control environment required by ISA 400 “Risk Assessments and Internal Control”, the auditor may find it more cost-effective not to make a further review of general controls or application controls, but to concentrate audit efforts on substantive procedures. This may entail more extensive physical examination and confirmation of assets, more tests of transactions, larger sample sizes and greater use of computer assisted audit techniques.
28. Where the level of general controls appears adequate, the auditor may decide to adopt a different approach. For example, an entity processing a large number of sales transactions on a stand-alone PC may establish control procedures that reduce control risk.
29. Stand-alone PCs are frequently encountered in small entities. IAPS 1005 “The Special Considerations in the Audit of Small Entities” provides further guidance. Based on a preliminary review of controls, the audit plan might include testing the controls the auditor intends to rely on.

**INTERNATIONAL AUDITING
PRACTICE STATEMENT 1002**

IT ENVIRONMENTS—ON-LINE COMPUTER SYSTEMS

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This Statement does not establish any new basic principles or essential procedures; its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of the ISAs when on-line computer systems are used in the production of information that is material to the financial statements of the entity. The auditor exercises professional judgment to determine the extent to which any of the audit procedures described in this Statement may be appropriate in the light of the requirements of the ISAs and the entity’s particular circumstances.

The auditor understands and considers the characteristics of an IT environment because they affect the design of the accounting system and related internal controls. Accordingly, an IT environment may affect the overall audit plan including the selection of internal controls the auditor intends to rely on and the nature, timing and extent of audit procedures.

The IAPC approved this International Auditing Practice Statement in June 2001 for publication in July 2001.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where there is no PSP, the IAPS applies in all material respects to the public sector.

Introduction

1. This Statement describes the effects of an on-line computer system on the accounting system and related internal controls and on audit procedures.

On-Line Computer Systems

2. On-line computer systems are computer systems that enable users to access data and programs directly through terminal devices. Such systems may comprise mainframe computers, minicomputers or a network of connected PCs. When the entity uses an on-line computer system, the technology is likely to be complex and linked with the entity's strategic business plans. The audit team may require special IT skills to make inquiries and to understand the implications of the responses obtained.¹ The auditor may need to consider using the work of an expert (see ISA 620 "Using the Work of an Expert").
3. On-line systems allow users to directly initiate various functions such as:
 - Entering transactions (for example, sales transactions in a retail store, cash withdrawals in a bank and shipment of goods in a plant);
 - Making inquiries (for example, current customer account status or balance information);
 - Requesting reports (for example, a list of inventory items with negative "on hand" quantities);
 - Updating master-files (for example, setting up new customer accounts and changing general ledger codes); and
 - Electronic commerce activities (for example, placing orders and paying for goods over the Internet).
4. On-line computer systems use many different types of terminal devices. The functions they perform vary widely, and depend on their logic, transmission, storage and basic processing capabilities. Types of terminal devices are:
 - (a) General Purpose Terminals, such as:
 - Basic keyboard and screen—used for entering data without any validation within the terminal and for displaying data from the computer system on the screen. For example, in entering a sales order, the main computer validates the product code and the terminal screen displays the result of the validation.
 - Intelligent terminal—used for the functions of the basic keyboard and screen with the additional functions of validating data within the terminal, maintaining transaction logs and performing other local

¹ See IEG 11 "Information Technology In The Accounting Curriculum" issued by the Education Committee of IFAC, which defines the broad content areas and specific knowledge and skills required by all professional accountants in connection with IT applied in a business context.

processing. In the above sales order example, the intelligent terminal verifies the correct number of characters in the product code and the main computer verifies the existence of the product code in the master-file.

- PCs—used for all of the functions of an intelligent terminal with additional local processing and storage capabilities. Continuing the above example, the PC may perform all the verifications of the product code.

(b) Special Purpose Terminals, such as:

- Point-of-sale devices—used to record sales transactions as they occur and to transmit them to the main computer. On-line cash registers and optical scanners used in the retail trade are typical point-of-sale devices.
- Automated teller machines—used to initiate, validate, record, transmit and complete various banking transactions. Depending on the design of the system, certain of these functions are performed by the automated teller machine and others are performed on-line by the main computer.
- Hand-held wireless devices for entering data from remote locations.
- Voice Response Systems—used to allow user interaction with the computer over a telecommunications network based on verbal instructions issued by the computer. The customer communicates using a tone-generating device, which is often the keypad on the customer's telephone. Common applications include telephone banking and bill payment systems.

5. Terminal devices may be found either locally or at remote sites. Local terminal devices are connected directly to the computer through cables, whereas remote terminal devices require the use of telecommunications to link them to the computer. In some cases, however, even local terminals may be connected using telecommunications links or wireless communication links. Terminal devices may be accessed by many users, for different purposes, in different locations, all at the same time. Users such as customers or suppliers may be within the entity or outside. In such cases, application software and data are kept on-line to meet users' needs. These systems also require other software, such as access control software and software that monitors on-line terminal devices.
6. Increased sharing of system resources through LANs and WANs has led to the growth of distributed on-line processing. Client/Server systems have resulted in applications being split, so that processing can be performed across several machines. In a client/server environment, the processing of data takes place on the server and the desktop computer (client).

7. Employees, business partners, customers and other third parties may obtain access to an organization's on-line applications by using the Internet or other remote access services. External parties may access the organization's applications through electronic data interchange (EDI) or other electronic commerce applications.
8. In addition to the users of these systems, programmers may use the on-line capabilities to develop new programs and maintain existing programs. Computer supplier personnel may also have on-line access to provide maintenance and support services.

Types of On-Line Computer Systems

9. On-line computer systems may be classified according to how information is entered into the system, how it is processed and when the results are available to the user. For purposes of this Statement, on-line computer systems functions are classified as follows:
 - (a) On-line/real-time processing;
 - (b) On-line/batch processing;
 - (c) On-line/memo update (and subsequent processing);
 - (d) On-line/inquiry; and
 - (e) On-line downloading/uploading processing.

On-Line/Real-Time Processing

10. In an on-line/real-time processing system, individual transactions are entered at terminal devices, validated and used to update related computer files immediately. An example is the application of cash receipts directly to customers' accounts. The results of such processing are then available immediately for inquiries or reports.

On-Line/Batch Processing

11. In a system with on-line input and batch processing, individual transactions are entered at a terminal device, subjected to certain validation checks and added to a transaction file that contains other transactions entered during the period. Later, during a subsequent processing cycle, the transaction file may be validated further and then used to update the relevant master-file. For example, journal entries may be entered and validated on-line and kept on a transaction file, with the general ledger master-file being updated on a monthly basis. Inquiries of, or reports generated from, the master-file will not include transactions entered after the last master-file update.

On-Line/Memo Update (and Subsequent Processing)

12. On-line input with memo update processing, also known as shadow update, combines on-line/real time processing and on-line/batch processing. Individual transactions immediately update a memo file containing information that has been extracted from the most recent version of the master-file. Inquiries are made from this memo file. These same transactions are added to a transaction file for subsequent validation and updating of the master-file on a batch basis. For example, the withdrawal of cash through an automated teller machine is checked against the customer's balance on the memo file, and is then immediately posted to the customer's account on that file to reduce the balance by the amount of the withdrawal. From the user's perspective, this system will seem no different from on-line/real time processing since the results of data entered are available immediately. However, the transactions have not been subjected to complete validation before the master-file update.

On-Line/Inquiry

13. On-line inquiry restricts users at terminal devices to making inquiries of master-files. In such systems, the master-files are updated by other systems, usually on a batch basis. For example, the user may inquire of the credit status of a particular customer before accepting an order from that customer.

On-Line Downloading/Uploading Processing

14. On-line downloading refers to the transfer of data from a master-file to an intelligent terminal device for further processing by the user. For example, data at the head office representing transactions of a branch may be downloaded to a terminal device at the branch for further processing and preparation of branch financial reports. The results of this processing and other locally processed data may then be uploaded to the head office computer.

Characteristics of On-Line Computer Systems

15. The characteristics of on-line computer systems may apply to many of the types of on-line systems discussed in the previous section. The most significant characteristics relate to on-line data entry and validation, on-line access to the system by users, possible lack of visible transaction trail and potential access to the system by non-users, including programmers and other third parties (for example, through e-mail and the Internet). The particular characteristics of a specific on-line system will depend on the design of that system.
16. When data are entered on-line, they are usually subject to immediate validation checks. Data failing this validation are not accepted and a message may be displayed on the terminal screen, providing the user with the ability to correct the data and re-enter the valid data immediately. For example, if the

user enters an invalid inventory part number, an error message is displayed, allowing the user to re-enter a valid part number.

17. Users may have on-line access to the system that enables them to perform various functions (for example, to enter transactions and to read, change or delete programs and data files through the terminal devices). Unlimited access to all of these functions in a particular application is undesirable because it provides the user with the potential ability to make unauthorized changes to the data and programs. Unlimited access precludes segregation of duties and allows users access to all stages of processing and recording a transaction. The extent of this access depends on things such as the design of the particular application and the implementation of software designed to control access to the system.
18. An on-line computer system may be designed not to provide supporting documents for all transactions entered into the system. Such a system must be able to provide details of the transactions on request or by transaction logs or other means. Examples of these types of systems include orders received by a telephone operator who enters them on-line without written purchase orders, and cash withdrawals from automated teller machines.
19. Programmers may have on-line access to the system that enables them to develop new programs and modify existing programs. Unrestricted access provides the programmer with the potential to make unauthorized changes to programs and obtain unauthorized access to other parts of the system and would represent a serious control weakness. The extent of this access depends on the requirements of the system. For example, in some systems, programmers ordinarily have access only to programs maintained in a separate program development and maintenance library. Programmers may, however, be authorized to change the operational programs in emergencies that require changes to programs kept on-line. In such cases, formal control procedures would be followed after the emergency to ensure appropriate authorization and documentation of the changes.

Internal Control in an On-Line Computer System

20. Applications in an on-line environment may have greater exposure to unauthorized access and update. An entity's security infrastructure plays an important part in ensuring the integrity of the information produced. The auditor, therefore, considers the security infrastructure before examining the general and application controls. The entity may need to establish suitable general controls to mitigate the risks of viruses, unauthorized access and the potential destruction of audit trails. Hence access controls are particularly important to on-line processing.
21. These controls may include the use of passwords and specialized access control software, such as on-line monitors, that maintains control over the menus, authorization tables, passwords, files and programs that users are permitted to access. They may also include physical controls such as the use of

key locks on terminal devices, locked computer rooms and inactivity timeouts. Other important aspects of control in an on-line computer system include:

- Controls over passwords: procedures for the assignment and maintenance of passwords to restrict access to authorized users;
- System development and maintenance controls: additional procedures to ensure that controls essential to on-line applications, such as passwords, access controls, on-line data validation and recovery procedures, are included in the system during its development and maintenance; the controls are also designed to ensure that changes to systems operate as expected and are made in the correct manner;
- Programming controls;
- Transaction logs; and
- Firewalls.

22. Certain application controls are particularly important to on-line processing. These include the following:

- Pre-processing authorization. Authorization to initiate a transaction, for example, by using a bank card together with a personal identification number before being able to make a cash withdrawal through an automated teller machine.
- Terminal device edit, reasonableness and other validation tests. Programmed routines that check the input data and processing results for completeness, accuracy and reasonableness. These routines include sequence, limit, range and reasonableness checks and may be performed on an intelligent terminal device or on the central computer.
- Input error reporting and handling. Procedures to ensure that all input errors are properly reported, identified and rejected from further processing, corrected and resubmitted for processing in a timely manner. These procedures will generally comprise a mix of both manual and automated routines.
- Cut-off procedures. Procedures that ensure transactions are processed in the proper accounting period. These are particularly necessary in systems that have a continuous flow of transactions. For example, in on-line systems where terminal devices in various locations record sales orders and shipments, there is a need to coordinate the actual shipment of goods, inventory release and invoice processing.
- File controls. Procedures that ensure the correct data files are used for on-line processing.
- Master file controls. Changes to master-files are controlled by procedures similar to those used for controlling other input transaction data. More stringent enforcement of these control procedures may be necessary

because master file data may have a pervasive effect on processing results.

- **Balancing.** The process of establishing control totals over data being submitted for processing through the on-line terminal devices and comparing the control totals during and after processing to ensure that complete and accurate data are transferred to each processing phase. These balancing controls are important to monitoring completeness and accuracy controls in a real-time processing environment. They should be included in the automated program routines whenever possible.
- Control may be established by an independent function that generally:
 - (a) Receives all data for processing;
 - (b) Ensures that all data are authorized and recorded;
 - (c) Follows up all errors detected during processing;
 - (d) Verifies the proper distribution of output; and
 - (e) Restricts physical access to application programs and data.

Separate controls are ordinarily required over master file and transaction data.

Effect of On-Line Computer Systems on the Accounting System and Related Internal Controls

23. The effect of an on-line computer system on the accounting system and the associated risks will generally depend on:
 - (a) The extent to which the on-line system is being used to process accounting applications;
 - (b) The type and significance of financial transactions being processed; and
 - (c) The nature of files and programs the applications use.

The entity's security infrastructure plays an important part in controlling the effect of the risks created by the entity's use of an on-line environment.

24. Factors such as the following may reduce the risk of errors occurring because of the entity's use of on-line systems:
 - Performing data entry at or near the point where transactions originate reduces the risk that the transactions will not be recorded.
 - Immediate correction and re-entering of invalid transactions reduces the risk that such transactions will not be corrected and resubmitted quickly.
 - Data entry performed by individuals who understand the nature of the transactions involved may be less prone to error than when performed by individuals unfamiliar with the nature of the transactions.

- Processing transactions immediately reduces the risk that they will be processed in the wrong accounting period.
 - Authentication and authorization carried out at or near the point where transactions originate reduces the risk of impersonation or other unauthorized access to or manipulation of data.
25. The risk of errors in on-line computer systems may be increased for the following reasons:
- Locating terminal devices throughout the entity increases the opportunity for unauthorized use of a terminal device and the entry of unauthorized transactions.
 - On-line terminal devices may provide easier opportunity for unauthorized uses such as:
 - Modification of previously entered transactions or balances;
 - Modification of computer programs; or
 - Access to data and programs from remote locations.
 - If on-line processing is interrupted for any reason, for example, due to faulty telecommunications, there may be a greater chance that transactions or files may be lost and that the recovery may not be accurate and complete.
 - On-line access to data and programs from remote sites through telecommunications may provide greater opportunity for access to data and programs by unauthorized persons. Organizations that have links to the Internet require greater controls, such as firewalls, to manage the risk of unauthorized access to data and programs.
 - The use of electronic commerce and EDI for the exchange of documents between two organizations results in the loss of traditional paper audit trails, including invoices and purchase orders.
26. The characteristics of on-line computer systems, as described earlier in this Statement, illustrate some of the considerations influencing the effectiveness of controls in on-line computer systems. Such characteristics may have the following consequences:
- (a) There may not be printed source documents for every input transaction;
 - (b) Results of processing may be highly summarized; for example, only totals from individual on-line data entry devices can be traced to subsequent processing;
 - (c) The on-line computer system may not be designed to provide printed reports; for example, edit reports may be replaced by edit messages displayed on a terminal device screen;

- (d) On-line computer systems running real-time processes pose particular difficulties for auditors as it can be difficult to achieve a clear cut-off of data. It can also be difficult in some IT environments to stop real-time processing long enough to obtain copies of data files or to run important reports for audit purposes at period end; and
- (e) In the event that real time systems have to be restored, it is difficult to ensure that all of the data is properly reinstated and, importantly, that all systems integration interfaces and data feeds are reset to the date and time of the back-up data.

Effect of On-Line Computer Systems on Audit Procedures

- 27. Generally, in a well-designed and controlled on-line computer system, it is likely that the auditor will test general and application controls. If those controls are deemed satisfactory, the auditor will place greater reliance on internal controls in the system when determining the nature timing and extent of audit procedures. The characteristics of on-line computer systems may make it more effective for the auditor to perform a pre-implementation review of new on-line accounting applications rather than to review the applications after installation. To be fully effective, the review may need to extend to other applications that provide data for those accounting applications; the auditor may also test that the new system operates and is implemented as designed. The pre-implementation review may provide the auditor with an opportunity to request additional functions, such as detailed transaction listings, or controls within the application design. It may also provide the auditor with sufficient time to develop and test audit procedures in advance of the system's use. In contrast, when the entity adopts a policy of continuous systems' upgrading, the change management procedures adopted may be critical to the on-going effectiveness of the controls in place. The auditor may therefore examine the change management procedures rather than perform pre-implementation reviews.
- 28. The following matters are of particular importance to the auditor in an on-line computer system:
 - (a) Authorization, completeness and accuracy of on-line transactions through the implementation of appropriate controls at the time when the transaction is accepted for processing;
 - (b) Integrity of records and processing, due to many users and programmers having on-line access to the system; and
 - (c) Necessary changes in the performance of audit procedures, including the use of CAATs (see International Auditing Practice Statement 1009 "Computer Assisted Audit Techniques"), due to matters such as:
 - The need for audit teams with technical skills in on-line computer systems;

- The effect of the on-line computer system on the timing of audit procedures;
 - The lack of visible transaction trails;
 - Procedures carried out during the audit planning stage (see paragraph 29)
 - Audit procedures performed concurrently with on-line processing (see paragraph 30); and
 - Procedures performed after processing has taken place (see paragraph 31).
29. Procedures carried out during the planning stage may include the following:
- The participation on the audit team of individuals with technical proficiency in on-line computer systems and related controls;
 - Identification of any new remote access facilities; and
 - Preliminary determination, during the risk assessment process, of the impact of the system on the audit procedures.
30. Audit procedures performed concurrently with on-line processing may include tests of the controls over the on-line applications. For example, this may be by means of entering test transactions through the on-line terminal devices or by the use of audit software. These tests may be used either to confirm the auditor's understanding of the system or to test controls such as passwords and other access controls. Where the entity permits access through the Internet, audit procedures can include tests of firewalls and other authorization and access controls, as well as tests of transaction processing. To avoid the inadvertent corruption of client records, the auditor reviews concurrent procedures with appropriate client personnel and obtains approval before conducting the tests.
31. Procedures performed after processing has taken place may include the following:
- Tests of controls over transactions logged by the on-line system for authorization, completeness and accuracy;
 - Substantive procedures covering transactions and processing results rather than tests of control, where the former may be more cost-effective or where the system is not well-designed or controlled; and
 - Reprocessing transactions as either a test of control or a substantive procedure.

**INTERNATIONAL AUDITING
PRACTICE STATEMENT 1003**

IT ENVIRONMENTS—DATABASE SYSTEMS

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The International Auditing Practices Committee (“IAPC”) of the International Federation of Accountants issues International Auditing Practices Statements (“Statements”) to provide practical assistance to auditors in implementing the International Standards on Auditing (“ISAs”) or to promote good practice. Statements do not have the authority of ISAs.

This Statement does not establish any new basic principles or essential procedures; its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of the ISAs when database systems are used in the production of information that is material to the financial statements of the entity. The auditor exercises professional judgment to determine the extent to which any of the audit procedures described in this Statement may be appropriate in the light of the requirements of the ISAs and the entity’s particular circumstances.

The auditor understands and considers the characteristics of an IT environment because they affect the design of the accounting system and related internal controls. Accordingly, an IT environment may affect the overall audit plan including the selection of internal controls the auditor intends to rely on and the nature, timing and extent of audit procedures.

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Introduction

1. This Statement describes the effects of a database system on the accounting system and related internal controls and on audit procedures.
2. A database is a collection of data that is shared and used by many different users for different purposes. Each user may not necessarily be aware of all the data stored in the database, or of the ways that the data may be used for multiple purposes. Generally, individual users are aware only of the data that they use and may view the data as computer files utilized by their applications.
3. When an entity uses a database system, the technology is likely to be complex and may be linked with the entity's strategic business plans. The audit team may require special IT skills to make appropriate inquiries and to understand the implications of the responses obtained¹. The auditor may need to consider using the work of an expert (see ISA 620 "Using the Work of an Expert").

Database Systems

4. Database systems consist principally of two components: the database and the database management system (DBMS). Database systems interact with other hardware and software aspects of the overall computer system.
5. The software that creates, maintains and operates the database is referred to as DBMS software. Together with the operating system, the DBMS facilitates the physical storage of the data, maintains the interrelationships between the data, and makes the data available to application programs. It also provides controlled access methods to establish basic security measures over the data. Usually, the DBMS software is supplied by a commercial vendor but will need to be adapted to the entity's needs.
6. The guidance in this statement applies to database systems used in multiple user environments. Although database systems may reside on any type of computer system, including PCs, this Statement does not relate to PC environments with only a single user.

Database System Characteristics

7. Database systems are distinguished by two important characteristics: data sharing and data independence. These characteristics ordinarily require the use of a data dictionary (paragraph 11) and the establishment of a data resource management (paragraphs 13-19).

¹ See IEG 11 "Information Technology In The Accounting Curriculum" issued by the Education Committee of IFAC, which defines the broad content areas and specific knowledge and skills required by all professional accountants in connection with IT applied in a business context.

Data Sharing

8. A database is composed of data set up with defined relationships and organized to permit many users to use the data in different application programs. Individual applications share the data in the database for different purposes. For example, an inventory item unit cost maintained by the database may be used by one application program to produce a cost of sales report and by another program to prepare an inventory valuation.

Data Independence from Application Programs

9. The DBMS records the data once for use by various application programs. This creates a need for data sharing and a need for data independence from application programs. In non-database systems, separate data files are maintained for each application. Similar data used by several applications may be repeated in several different files. In a database system, however, a single file of data (or database) is used by many applications, with data redundancy kept to a minimum.
10. DBMSs differ in the degree of data independence they provide. The degree of data independence is related to the ease with which personnel can make changes to application programs or to the database. True data independence is achieved when the structure of data in the database can be changed without affecting the application programs, and *vice versa*.

Data Dictionary

11. A significant implication of data sharing and data independence is the potential for the recording of data only once for use in several applications. Because various application programs need to access these data, a software facility is required to keep track of the location of the data in the database. This software within the DBMS is known as a data dictionary. It also serves as a tool to maintain standardized documentation and definitions of the database environment and application systems. A data dictionary provides functions such as:
 - A facility to create or modify data definitions;
 - Validation of the data definitions provided to ensure their integrity;
 - Prevention of unauthorized access or manipulations of the data definitions; and
 - Interrogation and reporting facilities that allow the database administrator to make inquiries on the data definitions.
12. Databases may be structured as flat file databases, or as relational databases. In a flat file database, all the data concerning one record are stored as part of that record. With a relational database, data are stored as a series of tables, with links between the tables as necessary. Relational databases minimize the

duplication of stored data, as data shared by more than one record need to be stored only once. The data themselves may comprise objects for use with object-oriented applications. This can lead to complicated data structures.

Data Resource Management

13. Data resource management forms an essential organizational control in ensuring data integrity and compatibility. In a database environment the methods of informational control and usage change from an application-orientated approach to an organization-wide approach. In contrast to traditional systems where each application is a separate system with its own reporting and controls, in a database environment, many controls may be centralized and the database is designed to serve the entire information needs of the organization.
14. The use of the same data by various application programs emphasizes the importance of centralized coordination of the use and definition of data and the maintenance of their integrity, security, accuracy and completeness. Data resource management is required to promote data integrity for the organization as a whole and includes a data administration function (refer to paragraph 15) and a database administration function (refer to paragraphs 16-19). The data administration function is concerned with the “ownership” of data, its meaning, and its relationship with other data and its entity-wide integrity. In contrast, the database administration function is primarily concerned with the technical implementation of the database, the day-to-day operations of the database and the policies and procedures governing its access and everyday usage.

Data Administration

15. The data administration function manages data as an organizational resource and includes responsibilities for:
 - The development and implementation of a data resource management strategic plan and policies, which support the entity’s business plans by achieving cost-effective use of the organization’s data;
 - The creation and maintenance of a corporate data model or architecture (sometimes referred to as an enterprise data model);
 - The coordination and integration of system data models;
 - Obtaining agreement among users about definitions and format of data;
 - Resolving conflicts about incompatible representation and data;
 - Establishing a corporate-wide data dictionary and managing the organization’s naming and definition standards;

- Establishing data standards and procedures for:
 - Data naming;
 - Data usage;
 - Data security;
 - Data definition compilation;
 - Data modeling; and
- Providing training and consulting to users and the data information technology team members (system developers and database administrators) concerning all aspects of data resource management.

Database Administration

16. Coordination is usually the responsibility of a group of individuals who are typically referred to as “database administration.” The individual who heads this function may be referred to as the “database administrator.” Generally, the database administration function takes responsibility for the definition, structure, security, operational control and efficiency of databases, including the definition of the rules for accessing and storing data.
17. Database administration tasks may also be performed by individuals who are not part of a centralized database administration group. When the tasks of database administration are distributed among existing organizational units rather than being centralized, the different tasks still need to be coordinated.
18. Database administration tasks typically include:
 - Defining the database structure and the description of the data model. Determining how data are defined, stored and accessed by users of the database to ensure that all their requirements are met on a timely basis.
 - Maintaining data integrity, security and completeness. Developing, implementing and enforcing the rules for data integrity, completeness and access. Responsibilities include:
 - Defining who is responsible for monitoring the appropriate origin of data and how such monitoring is performed;
 - Defining who may access data and how the access is accomplished (for example, through passwords and authorization tables);
 - Preventing the inclusion of incomplete or invalid data;
 - Detecting the absence of data;
 - Securing the database from unauthorized access and destruction;
 - Monitoring and follow-up of security incidents and regular backing-up of data; and

- Arranging total recovery in the event of a loss. In such a circumstance, the backup protocol covering the data tables is likely to be complex.
 - Coordinating computer operations related to the database. Assigning responsibility for physical computer resources and monitoring their use relative to the operation of the database.
 - Monitoring system performance. Developing performance measures to monitor the integrity of the data, the ability of the database to respond to the needs of users and the frequency of data changes and access.
 - Providing administrative support. Coordinating and liaising with the vendor of the DBMS, assessing new releases issued by the vendor of the DBMS and the extent of their effect on the entity, installing new releases and ensuring that appropriate internal education is provided.
19. Some applications may use more than one database. In these circumstances, the tasks of the database administration group will include the need to ensure:
- Adequate linkage between databases;
 - Coordination of functions; and
 - Consistency between data in different databases.

Internal Control in a Database Environment

20. Because an entity's security infrastructure plays an important part in ensuring the integrity of the information produced, the auditor considers that infrastructure before examining the general and application controls. Generally, internal control in a database environment requires effective controls over the database, the DBMS and the applications. The effectiveness of internal controls depends very much on the nature of data administration and the database administration tasks (paragraphs 15-19), and on how they are performed.
21. In database systems, general controls normally have a greater influence than application controls because of data sharing, data independence and other characteristics of database systems. General controls over the database, the DBMS and the activities of the data resource management (data administration and database administration) have a pervasive effect on application processing. As paragraph 29 notes, the use of a DBMS and the functions built into it can help to provide effective controls. The general controls of particular importance in a database environment can be classified into the following groups:
- (a) Standard approach for development and maintenance of application programs;
 - (b) Data model and data ownership;

- (c) Access to the database;
- (d) Segregation of duties;
- (e) Data resource management; and
- (f) Data security and database recovery.

Standard Approach for Development and Maintenance of Application Programs

22. Since many users share the data, using a standard approach to develop each new application program and to modify existing application programs may enhance control. This includes a formalized, step-by-step approach all individuals must follow when developing or modifying an application program. It also includes analyzing the effect of new and existing transactions on the database each time a modification is required. The resulting analysis would indicate the effects of the changes on the security and integrity of the database. Implementing a standard approach to develop and modify application programs is a technique that can help improve the accuracy, integrity and completeness of the database. The following are some of the controls that can help to achieve this:
- Definition standards are established and monitored for compliance.
 - Data backup and recovery procedures are established and implemented to ensure database availability;
 - Various levels of access control for data items, tables and files are established to prevent inadvertent or unauthorized access;
 - Controls are established to ensure accuracy, completeness and consistency of data elements and relationships in the database. However, in complex systems, the systems design may not always provide users with controls that prove the completeness and accuracy of data and there may be increased risk that the DBMS will not always identify data or index corruptions; and
 - Database restructuring procedures are followed when making logical, physical and procedural changes.

Data Model and Data Ownership

23. In a database environment, where many individuals may use programs to input and modify data, the database administrator needs to ensure there is a clear and definite assignment of responsibility for the accuracy and integrity of each item of data. A single data owner should be assigned responsibility for defining access and security rules, such as who can use the data (access) and what functions they can perform (security). Assigning specific responsibility for data ownership helps to ensure the integrity of the database. For example, the credit manager may be the designated “owner” of a customer’s credit limit and would be responsible for determining the authorized users of that

information. If several individuals are able to make decisions affecting the accuracy and integrity of given data, the likelihood increases of the data becoming corrupted or improperly used. The controls over user profiles are also important when using a database system, not only to establish authorized access but also, to detect violations or attempted violations.

Access to the Database

24. User access to the database can be restricted through access controls. These restrictions apply to individuals, terminal devices and programs. For passwords to be effective, adequate procedures are required for changing passwords, maintaining the secrecy of passwords, and reviewing and investigating attempted security violations. Relating passwords to defined terminal devices, programs and data helps to ensure that only authorized users and programs can access, amend or delete data. For example, the credit manager may give sales clerks authority to refer to a customer's credit limit, whereas a warehouse clerk might not have such authorization.
25. The use of authorization tables may further control user access to the various elements of the database. Improper implementation of access procedures can result in unauthorized access to the database. Appropriate controls also ensure that data stored is convertible into a human-readable format within a reasonable time.

Segregation of Duties

26. The responsibilities for performing the various activities required to design, implement and operate a database are divided among technical, design, administrative and user personnel. Their duties include system design, database design, administration and operation. Maintaining adequate segregation of these duties is necessary to ensure the completeness, integrity and accuracy of the database. For example, individuals responsible for modifying personnel database programs should not be the same ones who are authorized to change individual pay rates in the database.

Data Security and Database Recovery

27. Databases are likely to be used by people in many different parts of an entity's operations. This means that many parts of the entity would be affected if the data were unavailable or contained errors. Accordingly, the general controls for data security and database recovery assume a high level of importance in database systems.

The Effect of Databases on the Accounting System and Related Internal Controls

28. The effect of a database system on the accounting system and the associated risks will generally depend on factors such as:

- The extent to which databases are being used by accounting applications;
 - The type and significance of financial transactions being processed;
 - The nature and structure of the database, the DBMS (including the data dictionary), the database administration tasks and the applications (for example, batch or on-line update); and
 - The general and application controls that are particularly important in a database environment.
29. Database systems typically provide the opportunity for greater reliability of data than non-database systems. In such systems general controls assume a greater importance than application controls. This can result in reduced risk of fraud or error in accounting systems where databases are used. The following factors, combined with adequate controls, contribute to this improved reliability of data.
- Improved consistency of data is achieved because data are recorded and updated only once, rather than being stored in several files and updated at different times and by different programs.
 - Integrity of data will be improved by effective use of facilities included in the DBMS, such as recovery/restart routines, generalized edit and validation routines, and security and control features.
 - Other functions available with the DBMS can facilitate control and audit procedures. These functions include report generators, which may be used to create balancing reports, and query languages, which may be used to identify inconsistencies in the data.
30. Alternatively, the risk of misstatement may increase if database systems are used without adequate controls. In a typical non-database environment, controls exercised by individual users may compensate for weaknesses in general controls. In a database system, however, individual users cannot always compensate for inadequate database administration controls. For example, accounts receivable personnel cannot effectively control accounts receivable data if other personnel are not restricted from modifying accounts receivable balances in the database.

The Effect of Databases on Audit Procedures

31. Audit procedures in a database environment will be affected principally by the extent to which the accounting system uses the data in the database. Where significant accounting applications use a common database, the auditor may find it cost-effective to use some of the procedures in the following paragraphs.

32. To obtain an understanding of the database control environment and the flow of transactions the auditor may consider the effect of the following on audit risk in planning the audit.
- The relevant access controls. People outside the traditional accounting function may use the databases, and the auditor considers the access controls over accounting data and all those who may have access to it.
 - The DBMS and the significant accounting applications using the database. Other applications within the entity may generate or alter data the accounting applications use. The auditor considers how the DBMS controls these data.
 - The standards and procedures for development and maintenance of application programs using the database. Databases, especially those on stand-alone computers, may often be designed and implemented by people outside the IT or accounting functions. The auditor considers how the entity controls the development of these databases.
 - The data resource management function. As discussed in paragraphs 13-19, this function plays an important role in maintaining the integrity of data stored on the database.
 - Job descriptions, standards and procedures for those individuals responsible for technical support, design, administration and operation of the database. With database systems, it is likely that a wider range of individuals have significant data responsibilities than would be the case with non-database systems.
 - The procedures used to ensure the integrity, security and completeness of the financial information contained in the database.
 - The availability of audit facilities within the DBMS.
 - The procedures used to introduce new versions of the database into operation.
33. When determining the extent of reliance on internal controls related to the use of databases in the accounting system The auditor may consider how the controls described in paragraphs 22-27 are used. If the auditor subsequently decides to rely on those controls, the auditor designs and performs appropriate tests.
34. When the auditor decides to perform tests of control or substantive procedures related to the database system, it will often be more effective to do so using computer assisted audit techniques. The fact that the data are all stored in one place and organized in a consistent manner makes extraction of samples easier. Also, databases may include data generated outside the accounting function, which will help make the application of analytical procedures more effective.
35. Audit procedures may include using the functions of the DBMS to:

- Test access controls;
- Generate test data;
- Provide an audit trail;
- Check the integrity of the database;
- Provide access to the database or a copy of relevant parts of the database to enable the use of audit software (see International Auditing Practice Statement 1009 “Computer Assisted Audit Techniques”); and
- Obtain information necessary for the audit.

Before using the DBMS facilities, the auditor considers whether they are functioning adequately.

36. If the database administration controls are inadequate, the auditor may not be able to compensate for weak controls by any amount of substantive work. Therefore, when it becomes clear that the controls in the database system cannot be relied on, the auditor considers whether performing substantive procedures on all significant accounting applications that use the database would achieve the audit objective. If the auditor is unable to overcome the weakness in the control environment with substantive work to reduce audit risk to an acceptably low level, ISA 700 requires the auditor to qualify or disclaim an opinion.
37. The characteristics of database systems may make it more effective for the auditor to perform a pre-implementation review of new accounting applications rather than to review the applications after installation. This pre-implementation review and review of the change management process may provide the auditor with an opportunity to request additional functions, such as built-in audit routines or controls within the application design. It may also provide the auditor with sufficient time to develop and test audit procedures in advance of the system’s use.

**INTERNATIONAL AUDITING
PRACTICE STATEMENT 1004**

**THE RELATIONSHIP BETWEEN BANKING
SUPERVISORS AND BANKS' EXTERNAL AUDITORS**

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International Auditing Practices Statements (Statements) are issued by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants to provide practical assistance to auditors in implementing the International Standards on Auditing (ISAs) or to promote good practice. Statements do not have the authority of ISAs.

This International Auditing Practice Statement has been prepared in association with the Basel Committee on Banking Supervision* (the Basel Committee). It was approved for publication by the International Auditing Practices Committee and by the Basel Committee. It is based on ISAs extant at 1 October 2001.

Banks play a vital role in economic life and the continued strength and stability of the banking system is a matter of general public concern. The separate roles of banking supervisors and external auditors are important in this regard. The growing complexity of banking makes it necessary that there be greater mutual understanding and, where appropriate, more communication between banking supervisors and external auditors.

The purpose of this Statement is to provide information and guidance on how the relationship between bank auditors and supervisors can be strengthened to mutual advantage, and it takes into account the Basel Committee's Core Principles for Effective Banking Supervision. However, as the nature of this relationship varies significantly from country to country the guidance may not be applicable in its entirety to all countries. The International Auditing Practices Committee and the Basel Committee hope, however, that it will provide useful guidance about the respective roles of the banking supervisors and external auditors in the many countries where the links are close or where the relationship is currently under study.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where no PSP is added, the IAPS is applicable in all material respects to the public sector.

* The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

Introduction

1. Banks play a central role in the economy. They hold the savings of the public, provide a means of payment for goods and services and finance the development of business and trade. To perform these functions securely and efficiently, individual banks must command the confidence of the public and those with whom they do business. The stability of the banking system, both nationally and internationally, has therefore come to be recognized as a matter of general public interest. This public interest is reflected in the way banks in almost all countries, unlike most other commercial enterprises, are subject to prudential supervision by central banks or specific official agencies.
2. Banks' financial statements are also subject to audit by external auditors. The external auditor conducts the audit in accordance with applicable ethical and auditing standards, including those calling for independence, objectivity, professional competence and due care, and adequate planning and supervision. The auditor's opinion lends credibility to the financial statements and promotes confidence in the banking system.
3. As the business of banking grows in complexity, both nationally and internationally, the tasks of banking supervisors and external auditors are becoming more and more demanding. In many respects, banking supervisors and external auditors face similar challenges and, increasingly, their roles are being perceived as complementary. Not only do banking supervisors benefit from the results of the auditors' work, but they may also turn to the external auditor to undertake additional tasks when these tasks contribute to the performance of their supervisory roles. At the same time, external auditors, in carrying out their role, also look to banking supervisors for information that can help in discharging their responsibilities more effectively.
4. The International Auditing Practices Committee and the Basel Committee share the view that greater mutual understanding about the respective roles and responsibilities of banking supervisors and external auditors and, where appropriate, communication between them improves the effectiveness of audits of banks' financial statements and supervision to the benefit of both disciplines.
5. The roles and responsibilities of a bank's board of directors¹ and management, the bank's external auditors, and the banking supervisors in different countries derive from law, custom and, for external auditors, professional practice. This Statement is not intended to challenge or change these roles or responsibilities. Rather, it is intended to provide a better understanding of the nature of the

¹ The notions of "board of directors" and "management" are used, not to identify legal constructs, but rather to label two decision-making functions within a bank. Under the Glossary of Terms for ISAs, management comprises officers and others who also perform senior management functions. The Basel Core Principles refer to the functions of the board of directors to describe the functions of those charged with the governance of a bank. The principles set out in this paper are to be applied in accordance with the corporate governance structure of the country in which the bank is based. The Basel Committee's paper "Enhancing Corporate Governance for Banking Organisations" published in September 1999 should be referred to.

roles of bank's boards of directors and management, external auditors, and banking supervisors, since misconceptions about such roles could lead to inappropriate reliance being placed by one on the work of another. This Statement seeks to remove possible misconceptions and suggests how each might make more effective use of the work performed by the other. The Statement accordingly:

- (a) Sets out the primary responsibility of the board of directors and management (paragraphs 8–13);
 - (b) Examines the essential features of the role of external auditors (paragraphs 14–27)
 - (c) Examines the essential features of the role of banking supervisors (paragraphs 28–45)
 - (d) Reviews the relationship between the banking supervisor and the bank's external auditor (paragraphs 46–55); and
 - (e) Describes additional ways in which external auditors and the accountancy profession can contribute to the supervisory process (paragraphs 56–70).
6. In September 1997 the Basel Committee published its Core Principles for Effective Banking Supervision, known as the Basel Core Principles. The Basel Core Principles (which are used in country assessments by organizations such as the World Bank and the International Monetary Fund) are intended to serve as a basic reference for an effective supervisory system internationally and in all countries. This Statement has been prepared taking into account the Basel Core Principles.
 7. The Statement has been prepared with full awareness of the significant differences that exist in national institutional and regulatory frameworks, notably in accounting standards, in supervisory techniques and in the extent to which, in some countries, external auditors currently perform tasks at the request of banking supervisors. In some countries, banking supervisors and external auditors already have closer relationships than are indicated in this Statement. The arrangements suggested in this Statement do not replace, existing relationships. While this Statement is not intended to be prescriptive, it is hoped that the guidance expressed in it will be relevant to all situations, although it will obviously address the situations in some countries more directly than in others.

The Responsibility of the Bank's Board of Directors and the Management

8. The primary responsibility for the conduct of the business of a bank is vested in the board of directors and the management appointed by it. This responsibility includes, among other things, ensuring that:
 - Those entrusted with banking tasks have sufficient expertise and integrity and that there are experienced staff in key positions;

- Adequate policies, practices and procedures related to the different activities of the bank are established and complied with, including:
 - The promotion of high ethical and professional standards;
 - Systems that accurately identify and measure all material risks and adequately monitor and control these risks;
 - Adequate internal controls, organizational structures and accounting procedures;
 - The evaluation of the quality of assets and their proper recognition and measurement;
 - “Know your customer” rules that prevent the bank being used, intentionally or unintentionally, by criminal elements;
 - The adoption of a suitable control environment, aimed at meeting the bank’s prescribed performance, information and compliance objectives;
 - The testing of compliance and the evaluation of the effectiveness of internal controls by the internal audit function;
 - Appropriate management information systems are established;
 - The bank has appropriate risk management policies and procedures;
 - Statutory and regulatory directives, including directives regarding solvency and liquidity, are observed; and
 - The interests not only of the shareholders but also of the depositors and other creditors are adequately protected.
9. Management is responsible for preparing financial statements in accordance with the appropriate financial reporting framework and for establishing accounting procedures that provide for the maintenance of documentation sufficient to support the financial statements. This responsibility includes ensuring that the external auditor who examines and reports on the financial statements has complete and unhindered access to, and is provided with, all necessary information that can materially affect them and, consequently, the auditor’s report on them.² Management also has the responsibility to provide all information to the supervisory agencies that such agencies are entitled by law or regulation to obtain.
10. In many countries, audit committees have been set up to meet the practical difficulties that may arise in the board of directors fulfilling its task of

² In some countries, branches of overseas banks are only required to provide financial information (including abbreviated financial statements) prepared in accordance with group accounting policies or national regulations. This financial information may or may not be subject to an external audit requirement. The guidance in this statement is also applicable in an appropriate and practical manner to such external audits.

ensuring the existence and maintenance of an adequate system of internal controls. In addition, such a committee reinforces both the internal control system and the internal audit function. In order to reinforce the audit committee's effectiveness, the internal and external auditors should be allowed and encouraged to attend the meetings of the audit committee. Regular meetings of the audit committee with the internal and external auditors help enhance the external auditors independence and the credibility of the internal auditors, and assist the audit committee to perform its key role on strengthening corporate governance. In some countries, law or regulations prescribe that such meetings must take place.

11. When so required by the board of directors or by applicable law or regulations, management is responsible for the establishment and the effective operation of a permanent internal audit function in a bank appropriate to its size and to the nature of its operations. This function is part of the ongoing monitoring of the system of internal controls because it provides an assessment of the adequacy of, and compliance with, the bank's established policies and procedures and assurance as to the adequacy, effectiveness and sustainability of the bank's risk management and control procedures and infrastructure independent of those with day-to-day responsibility for complying with those policies and procedures. In fulfilling its duties and responsibilities, management should take all necessary measures to ensure that there is a continuous and adequate internal audit function.
12. In order to be fully effective, the internal audit function should be independent of the organizational activities it audits or reviews and also should be independent from the every day internal control process. Every activity and every division, subsidiary or other component of the banking organization should fall within the scope of the internal audit function's review. The professional competence of each internal auditor and of the internal audit function as a whole is essential for the proper performance of that function. Therefore, the internal audit function should be adequately staffed with persons of the appropriate skills and technical competence who are free from operating responsibilities. The internal audit function should regularly report to the board of directors and management on the performance of the internal control and risk management systems and on the achievement of the internal audit function's objectives. Management should establish and approve a procedure ensuring the consideration and, if appropriate, the implementation of the internal audit function's recommendations.
13. The responsibilities of the board of directors and management are in no way diminished by the existence of a system for the supervision of banks by banking supervisors or by a requirement for the bank's financial statements to be audited by an external auditor.

The Role of the Bank's External Auditor

14. The objective of an audit of a bank's financial statements by an external auditor is to enable an independent auditor to express an opinion as to whether the bank's financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The financial statements ordinarily will have been prepared according to the financial reporting framework of the country in which the bank has its head office,³ and in accordance with any relevant regulations laid down by regulators in that country. Financial reporting frameworks may differ from country to country, and the financial reporting regime for banks in any given country may be quite different from the regimes for other commercial entities. The auditor's opinion on the financial statements, therefore, will be expressed in terms of the applicable national framework and regulations. It is possible for financial statements prepared under different frameworks and regulations to differ substantially while still being in accordance with the applicable national requirements. For this reason, ISA 700, "The Auditor's Report on Financial Statements" requires the auditor to identify the country of origin of the financial reporting framework used to prepare the financial statements when that financial reporting framework is not International Accounting Standards.
15. The external auditor's report is appropriately addressed as required by the circumstances of the engagement, ordinarily to either the shareholders or the board of directors. However, the report may be available to many other parties, such as depositors, other creditors and supervisors. The auditor's opinion helps to establish the credibility of the financial statements. The auditor's opinion, however, should not be interpreted as providing assurance on the future viability of the bank or an opinion as to the efficiency or effectiveness with which the management has conducted the affairs of the bank, since these are not objectives of the audit.
16. The auditor designs audit procedures to reduce to an acceptably low level the risk of giving an inappropriate audit opinion when the financial statements are materially misstated. The auditor assesses the inherent risk of material misstatements occurring (inherent risk) and the risk that the entity's accounting and internal control systems will not prevent or detect and correct material misstatements on a timely basis (control risk). The auditor assesses control risk as being high unless the auditor is able to identify controls that are likely to prevent or detect and correct a material misstatement and conducts tests of the controls that support a lower assessment of control risk. Based on the assessment of inherent and control risk, the auditor carries out substantive procedures to reduce the overall audit risk to an acceptably low level.
17. The auditor considers how the financial statements might be materially misstated and considers whether fraud risk factors are present that indicate the

³ In some countries, reporting in accordance with internationally accepted accounting standards, such as those issued or adopted by the International Accounting Standards Board, also is permitted.

possibility of fraudulent financial reporting or misappropriation of assets. The auditor designs audit procedures to reduce to an acceptably low level the risk that misstatements arising from fraud and error that are material to the financial statements taken as a whole are not detected. ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” lists fraud risk factors whose presence may alert the auditor to the possibility of fraud existing. In some countries, when the auditor determines that evidence of fraud exists, the auditor is required to disclose this information to the bank’s supervisor.

18. In carrying out the audit of a bank’s financial statements, the external auditor recognizes that banks have the following characteristics that generally distinguish them from most other commercial enterprises, and which the auditor takes into account in assessing the level of inherent risk.
 - They have custody of large amounts of monetary items, including cash and negotiable instruments, whose physical security has to be safeguarded during transfer and while being stored. They also have custody and control of negotiable instruments and other assets that are readily transferable in electronic form. The liquidity characteristics of these items make banks vulnerable to misappropriation and fraud. Banks therefore need to establish formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
 - They often engage in transactions that are initiated in one jurisdiction, recorded in a different jurisdiction and managed in yet another jurisdiction.
 - They operate with very high leverage (that is, the ratio of capital to total assets is low), which increases banks’ vulnerability to adverse economic events and increases the risk of failure.
 - They have assets that can rapidly change in value and whose value is often difficult to determine. Consequentially a relatively small decrease in asset values may have a significant effect on their capital and potentially on their regulatory solvency.
 - They generally derive a significant amount of their funding from short-term deposits (either insured or uninsured). A loss of confidence by depositors in a bank’s solvency can quickly result in a liquidity crisis.
 - They have fiduciary duties in respect of the assets they hold that belong to other persons. This may give rise to liabilities for breach of trust. Banks therefore need to establish operating procedures and internal controls designed to ensure that they deal with such assets only in accordance with the terms on which the assets were transferred to the bank.
 - They engage in a large volume and variety of transactions whose value may be significant. This necessarily requires complex accounting and

internal control systems and widespread use of information technology (IT).

- They ordinarily operate through a network of branches and departments that are geographically dispersed. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions with consequential difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- Transactions can often be directly initiated and completed by the customer without any intervention by the bank's employees, for example over the Internet or through automatic teller machines (ATMs).
- They often assume significant commitments without any initial transfer of funds other than, in some cases, the payment of fees. These commitments may involve only memorandum accounting entries. Consequently their existence may be difficult to detect.
- They are regulated by governmental authorities whose regulatory requirements often influence the accounting principles that banks follow. Non-compliance with regulatory requirements, for example, capital adequacy requirements, could have implications for the bank's financial statements or the disclosures therein.
- Customer relationships that the auditor, assistants, or the audit firm may have with the bank might affect the auditor's independence in a way that customer relationships with other organizations would not.
- They generally have exclusive access to clearing and settlement systems for checks and fund transfers, foreign exchange transactions, etc. They are an integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.
- They may issue and trade in complex financial instruments, some of which may need to be recorded at fair value in the financial statements. They therefore need to establish appropriate valuation and risk management procedures. The effectiveness of these procedures depends on the appropriateness of the methodologies and mathematical models selected, access to reliable current and historical market information, and the maintenance of data integrity.

19. A detailed audit of all transactions of a bank would be not only time-consuming and expensive but also impracticable. The external auditor therefore bases the audit on the assessment of the inherent risk of material misstatement, the assessment of control risk and testing of the internal controls designed to prevent or detect and correct material misstatements, and on substantive procedures performed on a test basis. Such procedures comprise one or more of the following: inspection, observation, inquiry and

confirmation, computation and analytical procedures. In particular, the external auditor is concerned about the recoverability and consequently the carrying value of loans, investments and other assets shown in the financial statements and about the identification and adequate disclosure in the financial statements of all material commitments and liabilities, contingent or otherwise.

20. While the external auditor has the sole responsibility for the audit report and for determining the nature, timing and extent of audit procedures, much of the work of internal auditing can be useful to the external auditor in the audit of the financial statements. The auditor, therefore, as part of the audit assesses the internal audit function insofar as the auditor believes that it will be relevant in determining the nature, timing and extent of the audit procedures.
21. ISA 610, “Considering the Work of Internal Auditing” requires external auditors to consider the activities of internal auditors and their effect, if any, on the nature, timing, and extent of the external auditor’s procedures. The external auditor considers the organizational status of the internal audit function, the scope of its function, the technical competence of its members and the professional care they exercise when assessing the work of the department.
22. Judgment permeates the auditor’s work. The auditor uses professional judgment in areas such as:
 - Assessing inherent and control risk and the risk of material misstatement due to fraud and error;
 - Deciding upon the nature, timing and extent of the audit procedures;
 - Evaluating the results of those procedures; and
 - Assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements.
23. An external auditor plans and conducts the audit to obtain reasonable assurance that misstatements in the bank’s financial statements which, individually or in aggregate, are material in relation to the financial information presented by those statements are detected. The assessment of what is material is a matter for the auditor’s professional judgment, and is influenced by the economic decisions that users of the bank’s financial statements will take on the basis of those financial statements. The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by other considerations such as legal and regulatory requirements and considerations relating to individual financial statement account balances and relationships. The process may result in different materiality levels depending on the aspect of the financial statements being considered. Similarly, the level of materiality used by an auditor when reporting on a bank’s financial statements may be different from the level used

when making special reports to banking supervisors. ISA 320, “Audit Materiality” discusses this in more detail.

24. In forming an opinion on the financial statements, the external auditor carries out procedures designed to obtain reasonable assurance that the financial statements are prepared in all material respects in accordance with an identified financial reporting framework. An audit does not guarantee all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error, because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions or intentional misrepresentation being made to the auditor. Such attempts at concealment may be even harder to detect when accompanied by collusion. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because boards of directors and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. Therefore, the auditor plans and performs an audit with an attitude of professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.
25. When the auditor discovers a misstatement material to the financial statements taken as a whole, including the use of an inappropriate accounting policy or asset valuation or a failure to disclose essential information, the auditor asks management to adjust the financial statements to correct the misstatement. If management refuses to make the correction the auditor issues a qualified or an adverse opinion on the financial statements. Such a report could have a serious effect on the credibility and even stability of the bank, and management therefore usually takes the steps necessary to avoid it. Likewise, an auditor issues a qualified opinion or a disclaimer of opinion if management has not provided the auditor with all the information or explanations the auditor requires.
26. As a supplementary but not necessarily integral part of the audit, the external auditor ordinarily communicates certain information to management. This information customarily contains comments on such matters as material weaknesses in internal control or misstatements that have come to the auditor’s attention during the course of the audit, but which do not warrant a modification of the audit report (either because additional procedures have been performed to compensate for a weakness in control or because the misstatements have been corrected in the financial statements or are immaterial in their context). The external auditor also communicates matters of governance to those charged with the governance of the bank. In some countries, the external auditor also submits, either as part of a statutory

requirement or by convention, a long-form report to management or to the banking supervisor on specified matters such as the composition of account balances or of the loan portfolio, liquidity and earnings, financial ratios, the adequacy of internal control systems, an analysis of banking risks, or compliance with legal or supervisory requirements.

27. In some countries, the external auditor is required to report promptly to the banking supervisor any fact or decision that is liable to:
- Constitute a material breach of laws or regulations;
 - Affect the bank's ability to continue as a going concern; or
 - Lead to a modified report.

The Role of the Banking Supervisor

28. The key objective of prudential supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors. In addition, supervision also is often directed toward verifying compliance with laws and regulations governing banks and their activities. However, in this Statement the focus is on the prudential aspect of the banking supervisor's role.
29. Banking supervision is based on a system of licensing, which allows supervisors to identify the population to be supervised and to control entry into the banking system. In order to qualify for and retain a banking license, entities must observe certain prudential requirements. These requirements may differ from country to country in their precise specification; some may be closely defined in regulation and others may be more broadly drawn, allowing the supervisory authority a measure of discretion in their interpretation. However, the following basic requirements for a banking license ordinarily are found in most systems of supervision:
- The bank must have suitable shareholders and members of the board (this notion includes integrity and standing in the business community as well as the financial strength of all major shareholders);
 - The bank's management must be honest and trustworthy and must possess appropriate skills and experience to operate the bank in a sound and prudent manner;
 - The bank's organization and internal control must be consistent with its business plans and strategies;
 - The bank should have a legal structure in line with its operational structure;
 - The bank must have adequate capital to withstand the risks inherent in the nature and size of its business; and
 - The bank must have sufficient liquidity to meet outflows of funds.

30. Further and more detailed requirements are often prescribed, including minimum numerical ratios for the adequacy of the bank's capital and liquidity. Whatever the precise form of the regulations, however, their objective is to set conditions to ensure that a bank conducts its business prudently and has adequate financial resources to overcome adverse circumstances and protect depositors from loss.
31. In addition to licensing new banks, most banking supervisors have the authority to review and reject any proposal to transfer significant ownership or a controlling interest in existing banks to other parties.
32. Ongoing banking supervision ordinarily is conducted on the basis of recommendations and guidance. However, banking supervisors have at their disposal recourse to legal powers to bring about timely corrective action when a bank fails to meet prudential requirements, when there are violations of laws or regulations, or when depositors are faced with a substantial risk of loss. In extreme circumstances, the supervisor may have the authority to revoke the bank's license.
33. One of the foundations of prudential supervision is capital adequacy. In most countries there are minimum capital requirements for the establishment of new banks and capital adequacy tests are a regular element in ongoing supervision. In the consultative package "The New Basel Capital Accord" issued by the Basel Committee in January 2001, the Basel Committee proposes a capital adequacy framework based on three complementary pillars: minimum capital requirements, a supervisory review process and market discipline.
 - The first pillar defines the minimum capital requirements for three broad categories of risks: credit risk, market risk and operational risk.
 - The second pillar, the supervisory review process, relies on the following principles. Banks must have sufficient solvency in relation to its risk profile and supervisors must have the ability to require banks to hold capital in excess of the minimum. Banks should assess internally and on an ongoing basis their capital adequacy based on their present and future risk profile and supervisors should review the banks' internal capital adequacy assessment procedure. Finally, supervisors must intervene early, taking into account the relatively illiquid nature of most bank assets and the limited options most banks have in raising capital quickly.
 - The third pillar, market discipline, enhances the role of market participants in encouraging banks to hold adequate levels of capital. In this respect, banks must disclose quantitative and qualitative information about their capital and risk profile.
34. Banks are subject to a variety of risks. Supervisors monitor and may limit a range of banking risks, such as credit risk, market risk (including interest and foreign exchange risk), liquidity and funding risk, operational risk, legal risk and reputational risk. Increasingly, supervisors are attempting to develop systems of measurement that will capture the extent of exposure to specific

risks (for example, the risks involved in derivative financial instruments). These systems often form the basis for specific controls or limits on the various categories of exposure.

35. The most significant of banking risks, in terms of historical loss experience, is the risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter (sometimes referred to as credit risk). It is not the banking supervisor's role to direct banks' lending policies, but it is essential for the supervisor to be confident that the bank has adopted a sound system for managing credit risk. The supervisor also evaluates the effectiveness of a bank's policies and practices for assessing loan quality. The supervisor seeks to be satisfied that the methods employed and judgments made by management to calculate allowances produce an aggregate amount of specific and general allowances that is adequate to absorb estimated credit losses, on a timely basis, in accordance with appropriate policies and procedures. In addition, the supervisor also seeks to ensure that credit risk is adequately diversified by means of rules to limit exposures, whether in terms of individual borrowers, industrial or commercial sectors or particular countries or economic regions.
36. Although it is difficult to assess, the quality of a bank's loans and other assets is one of the most critical determinants of its financial condition. Accordingly, accurate and prudent valuation of assets is of great importance for supervisors because it has a direct bearing on the determination of the reported amount of the bank's capital. As already indicated, capital is widely used as the supervisory standard against which exposures are measured or limited. While the proper valuation of assets is one of the primary responsibilities of management, the valuation process often involves considerable judgment. In general, unless the supervisor performs its own evaluation of this process to determine its accuracy and compliance with documented policies and procedures, the supervisor relies in large part on the management's judgment of the proper valuation of assets and on the fact that valuations that appear in the financial statements have been subjected to external audit.
37. Supervisors attach considerable importance to the need for banks to have in place internal controls that are adequate for the nature, scope and scale of their business. The purpose of internal controls is to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.
38. The development of sophisticated real-time computerized information systems has greatly improved the potential for control, but in turn has brought with it additional risks arising from the possibility of computer failure or fraud. The introduction of E-Commerce has also introduced significant new risks and requires, in turn, additional controls.

39. Supervisors are concerned to ensure that the quality of management is adequate for the nature and scope of the business. In regulatory environments in which on-site inspections are regularly carried out, the examiners have an opportunity to notice signs of management deficiencies. Elsewhere, the supervisor normally arranges to interview management on a regular basis and pursues other opportunities for contacts where they arise. Whatever the nature of the regulatory environment, the supervisor tries to use these opportunities to understand management's business plans and strategies and how it expects to achieve them. Similarly, the supervisor seeks to discover whether the bank is properly equipped to carry out its functions in terms of the skills and competence of its staff and the equipment and facilities at its disposal. The information gained from these contacts with management assists the supervisor in forming an opinion about management's competence.
40. Effective supervision requires the collection and analysis of information about supervised banks. For example, supervisors collect, review and analyze prudential reports and statistical returns from banks. These include basic financial statements as well as supporting schedules that provide greater detail. These reports are used to check adherence to certain prudential requirements and they also provide a basis for discussions with the bank's management. Off-site monitoring can often identify potential problems, particularly in the interval between on-site inspections, thereby providing early detection and prompting corrective action before problems become more serious.
41. Supervisors must have a means of validating the information they receive either through on-site inspections or the use of external auditors. On-site work, whether done by the banking supervisor's own staff or commissioned by the supervisor but undertaken by external auditors, is structured to provide independent verification of whether an adequate internal control system, meeting the specific criteria the supervisor mandates, exists at individual banks and whether the information provided by banks is reliable.
42. To enhance their understanding of a bank's corporate governance and system of operation, some supervisory authorities meet periodically with the bank's audit committee or its board of directors. This provides an opportunity for the audit committee or the board of directors to discuss any concerns it may have about the management of the bank and enables the supervisor to form a view as to the audit committee's effectiveness.
43. Banking supervisors are interested in ensuring that all the work performed by external auditors is carried out by auditors who:
- Are properly licensed and in good standing;
 - Have relevant professional experience and competence;
 - Are subject to a quality assurance program;
 - Are independent in fact and appearance of the bank audited;
 - Are objective and impartial; and

- Comply with any other applicable ethical requirements.⁴
44. In some countries, the banking supervisor has statutory powers over the appointment of external auditors, such as the right of approval or removal, and the right to commission an independent audit. These powers are intended to ensure that the external auditors the banks appoint have the experience, resources and skills necessary in the circumstances. Where there is no obvious reason for a change of external auditor, supervisors will also normally investigate the circumstances that caused the bank not to reappoint the auditor.
 45. Supervisors have a clear interest in ensuring high standards of bank auditing. Moreover, an important concern of supervisors is the independence of the external auditor who performs the audit of a bank, particularly when the auditor also provides certain types of non-audit services to the bank. Accordingly, supervisors seek to maintain close contact with national professional auditing bodies in order to address issues of mutual interest.

The Relationship Between the Banking Supervisor and the External Auditor

46. In many respects the banking supervisor and the external auditor have complementary concerns regarding the same matters though the focus of their concerns is different.
 - The banking supervisor is primarily concerned with maintaining the stability of the banking system and fostering the safety and soundness of individual banks in order to protect the interests of the depositors. Therefore, the supervisor monitors the present and future viability of banks and uses their financial statements in assessing their condition and performance. The external auditor, on the other hand, is primarily concerned with reporting on the bank's financial statements ordinarily either to the bank's shareholders or board of directors. In doing so, the auditor considers the appropriateness of management's use of the going concern assumption. The auditor considers the period of assessment used by management and, when that period is less than 12 months from the balance sheet date, asks management to extend the assessment period to at least 12 months from the balance sheet date. If management refuses to do so ISA 570, "Going Concern" requires the auditor to consider the need to modify the auditor's report as a result of the limitation of the auditor's work. The auditor also inquires of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the bank's ability to continue as a going concern.
 - The banking supervisor is concerned with the maintenance of a sound system of internal control as a basis for safe and prudent management of the bank's business. The external auditor, in most situations, is concerned

⁴ The auditor complies with relevant national ethical standards and the "Code of Ethics for Professional Accountants", issued by the International Federation of Accountants (the Code).

with the assessment of internal control to determine the degree of reliance to be placed on the system in planning and performing the audit.

- The banking supervisor must be satisfied that each bank maintains adequate records prepared in accordance with consistent accounting policies and practices that enable the supervisor to appraise the financial condition of the bank and the profitability of its business, and that the bank publishes or makes available on a regular basis financial statements that fairly reflect its condition. The external auditor is concerned with whether adequate and sufficiently reliable accounting records are maintained in order to enable the entity to prepare financial statements that do not contain material misstatements and thus enable the external auditor to express an opinion on those statements.

47. When a banking supervisor uses audited financial statements in the course of supervisory activities, the supervisor needs to bear in mind the following factors.

- Supervisory needs are not ordinarily the primary purpose for which the financial statements were prepared;
- An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement;
- The importance of the accounting policies used in the preparation of the financial statements as financial reporting frameworks require the exercise of judgment in their application and may allow choices in certain policies or how they are applied;
- Financial statements include information based on judgments and estimates made by the management and examined by the auditor;
- The financial position of the bank may have been affected by subsequent events since the financial statements were prepared;
- The supervisor cannot assume that the auditor's evaluation of internal control for the purposes of the audit will necessarily be adequate for the purposes for which the supervisor needs an evaluation, given the different purposes for which internal control is evaluated and tested by the supervisor and the auditor; and
- The controls and accounting policies that the external auditor considers may not be the ones that the bank uses when preparing information for the banking supervisor.

48. Nonetheless, there are many areas where the work of the banking supervisor and of the external auditor can be useful to each other. Communications from auditors to management and other reports submitted by auditors can provide supervisors with valuable insight into various aspects of the bank's operations.

It is the practice in many countries for such reports to be made available to the supervisors.

49. Similarly, external auditors may obtain helpful insights from information originating from the banking supervisor. When a supervisory inspection or a management interview takes place, the conclusions drawn from the inspection or interview are customarily communicated to the bank. These communications can be useful to auditors inasmuch as they provide an independent assessment in important areas such as the adequacy of the allowance for loan losses and focus attention on specific areas of supervisory concern. Supervisory authorities may also develop certain informal prudential ratios or guidelines that are made available to the banks and that can be of assistance to auditors in performing analytical reviews.
50. When communicating with management, both banking supervisors and external auditors are aware of the benefits that can flow to each other from knowledge of the matters contained in such communications. It is therefore advantageous for communications of this nature to be made in writing, so that they form part of the bank's records to which the other party should have access.
51. In order to preserve the concerns of both parties regarding the confidentiality of information acquired while carrying out their respective functions, it is normal that, when contacts between the banking supervisor and the external auditor become necessary, management of the bank is also present or at least informed. It is recommended that timely and appropriate measures be taken so that external auditors cannot be held liable for information disclosed in good faith to the supervisory authorities in accordance with applicable laws and regulations. These measures can take the form of legal initiatives or can be an agreement among the bank, its management, the external auditor and the supervisory authority. This is particularly true when the presence of management would compromise the discussion, for example, where the auditor believes that management is involved in fraudulent conduct.
52. ISA 260, "Communications of Audit Matters With Those Charged With Governance" identifies matters of governance interest and requires auditors to communicate those matters on a timely basis to those charged with governance.⁵ Audit matters of governance interest include only those matters

⁵ Ordinarily such matters include:

- The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
- The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
- The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
- Audit adjustments, whether or not recorded by the entity, that have or could have, a significant effect on the entity's financial statements;
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;

that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required, in an audit in accordance with ISAs, to design procedures for the specific purpose of identifying matters of governance interest. Certain audit matters of governance interest are likely to be of interest to banking supervisors, particularly where those matters may require urgent action by the supervisor. When required by the supervisory, legal, or regulatory framework or by a formal agreement or protocol, the auditor communicates such matters to the banking supervisor on a timely basis. In situations where there are no such requirements, agreements or protocols, the auditor encourages the bank's management or those charged with governance to communicate on a timely basis matters that, in the auditor's judgment, may be of urgent interest to the banking supervisor.⁶ Furthermore, even if there is no requirement to do so, the auditor considers communicating such matters to the banking supervisor when management or those charged with governance do not do so. In such circumstances, the auditor considers whether the law protects the auditor when such communications are made.

53. The following are examples of types of other matters that may come to the attention of the auditor and may require urgent action by the banking supervisor:

- Information that indicates a failure to fulfill one of the requirements for a banking license;
- A serious conflict within the decision-making bodies or the unexpected departure of a manager in a key function;
- Information that may indicate a material breach of laws and regulations or the bank's articles of association, charter, or by-laws;
- The intention of the auditor to resign or the removal of the auditor from office; and
- Material adverse changes in the risks of the bank's business and possible risks going forward.

In many cases the external auditor also communicates these matters to those charged with governance.

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- Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;
 - Expected modifications to the auditor's report;
 - Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management; and
 - Any other matters agreed upon in the terms of the engagement.

⁶ Clear requirements concerning the auditor's communication to banking supervisors are already established in many countries either by law, by supervisory requirement or by formal agreement or protocol. This is of mutual interest for both auditors and banking supervisors. In countries without such requirements, banking supervisors and accountancy bodies are encouraged to consider initiatives or support for appropriate measures in this regard.

54. In a number of countries, the external auditor carries out specific assignments or issues special reports in accordance with statutes or at the request of the banking supervisor to assist the supervisor in discharging its supervisory functions. These duties may include reporting upon whether:
 - Licensing conditions have been complied with;
 - The systems for maintaining accounting and other records and the systems of internal control are adequate;
 - The method used by the bank to prepare reports for the banking supervisor is adequate and the information included in these reports, which may include specified ratios of assets to liabilities and other prudential requirements, is accurate;
 - The organization is adequate based on criteria provided by the supervisory authority;
 - Laws and regulations are complied with; and
 - Appropriate accounting policies are adhered to.
55. Banking supervisors and internal and external auditors cooperate with each other to make their contributions to the supervisory process more efficient and effective. The cooperation optimizes supervision while allowing each party to concentrate on its own responsibilities. In some countries the cooperation may be based on periodic meetings of the supervisor and the external and internal auditors.

Additional Requests for the External Auditor to Contribute to the Supervisory Process

56. A supervisor's request to an external auditor to assist in specific supervisory tasks should be made in the context of a well-defined framework that is set forth in applicable law or a contractual agreement between the bank and the supervisor. These requests may in some cases be the subject of a separate engagement. In this situation, the following criteria should be established.
57. First, the basic responsibility for supplying complete and accurate information to the banking supervisor must remain with the bank's management. The external auditor's role is to report on that information or on the application of particular procedures. As such, the auditor does not assume any supervisory responsibilities, but, by providing this report, enables the supervisor to make judgments about the bank more effectively.
58. Second, the normal relationship between the external auditor and the audited bank needs to be safeguarded. If there are no other statutory requirements or contractual arrangements governing the external auditor's work, all information flows between the banking supervisor and the auditor typically are channeled through the bank except in exceptional circumstances. Thus, the banking supervisor will request the bank to arrange to obtain the information it

requires from the auditor and such information will be submitted to the supervisor through the bank. Any meetings between the external auditor and the banking supervisor will, except as indicated in paragraphs 51 and 52 above, be attended by representatives of the bank, and the bank's approval will be required before the auditor transmits copies of communications to management and other reports to the supervisor.⁷

59. Third, before concluding any arrangements with the banking supervisor, the external auditor considers whether any conflicts of interest may arise. If so, these need to be satisfactorily resolved before the commencement of the work, normally by obtaining the prior approval of the bank's management to undertake the assignment.
60. Fourth, the supervisory requirements must be specific and clearly defined in relation to the information required. This means that the supervisor needs, as far as possible, to describe the standards against which the bank's performance can be measured, so that the auditor can report whether or not they have been achieved. If, for example, information is required on the quality of loan assets, the supervisor has to specify what criteria are to be used in classifying the loans according to risk category. Similarly, wherever possible, some understanding must be reached between banking supervisors and external auditors regarding the concept of materiality.
61. Fifth, the tasks that the banking supervisor asks the external auditor to perform need to be within the auditor's competence, both technical and practical. The auditor may, for example, be requested to assess the extent of a bank's exposure to a particular borrower or country. However, without clear and specific guidance, the auditor will not be in a position to judge whether any particular exposures are excessive. In addition, audits are carried out at intervals and not continuously, so that, for example, it is not reasonable to expect the external auditor, in addition to the work necessary to conduct the audit, to carry out a complete evaluation of internal control or to monitor a bank's compliance with all supervisory rules except through an ongoing program of work over a period of time.
62. Sixth, the external auditor's task for the banking supervisor must have a rational basis. This means that except in special circumstances the task must be complementary to the regular audit work and can be performed more economically or more expeditiously than by the supervisor, either because of the auditor's specialized skills or because duplication is thereby avoided.
63. Finally, certain aspects of confidentiality need to be protected, in particular the confidentiality of information obtained by the external auditor through professional relationships with other audit clients and not available to the bank or the public.

⁷ Many banks furnish copies of the external auditor's communications to management and other special reports directly to the banking supervisor.

64. The way in which the external auditor's role can be extended depends on the nature of the national supervisory environment. For example, if the banking supervisor follows an active approach, with frequent and rigorous inspection, the assistance that might be asked of the external auditor will normally be minimal. If, on the other hand, there is a history of less direct supervision, primarily based on the analysis of reported information provided by bank's management, as opposed to inspection, or if supervisory resources are limited, the supervisor can benefit from the assistance that the external auditor can offer in providing assurance on the information obtained.
65. Currently, however, many countries are practicing a supervisory approach which contains elements of both inspection and analysis of reported information. As banking develops in complexity, inspection is proving more and more demanding in terms of supervisory resources. Many supervisory authorities that practice on-site inspection are thus being driven to place greater reliance on reported information, and look to the external auditor for assistance in those areas for which the auditor's skills are particularly suited.
66. Where banking supervisors have previously relied solely on their analysis of prudential returns, they have found that a certain degree of on-the-spot examination is a desirable safeguard. In these countries, therefore, the supervisors are relying more than before on external auditors to assist them by performing specific tasks (see paragraph 54).
67. In those countries where contacts between external auditors and banking supervisors have been close over a long period, a bond of mutual trust has been built up and extended experience of collaboration has enabled each to benefit from the other's work. Experience in those countries indicates that the conflicts of interest that auditors may in principle perceive as preventing close collaboration with supervisors assume less importance in practice and do not present an obstacle to a fruitful dialogue.

The Need for a Continuing Dialogue Between Banking Supervisors and the Accountancy Profession

68. If banking supervisors are to derive benefit from the work of external auditors on a continuing basis, supervisors should discuss current areas of supervisory concern with the accounting profession as a whole. This can be achieved through periodic discussions at the national level between the supervisory authorities and the professional accountancy bodies. Such discussions could cover areas of mutual concern. It is of considerable assistance to auditors in making informed judgments if they were to have as clear an understanding as possible of the supervisory authorities' knowledge and attitude on such matters. In the course of such discussions, supervisors should also have an opportunity to express their views on accounting policies and auditing standards generally and on specific audit procedures in particular. This assists in improving the general standard of audits of banks' financial statements. It is advisable for the banks' own industry associations to be involved in

discussions on these topics, for example, through the head of the internal audit function, to ensure that the views of all parties are taken into account.

69. Discussions between banking supervisors and professional accountancy bodies could also usefully include major auditing issues and topical accounting problems, such as the appropriate accounting techniques for newly developed instruments, and other aspects of financial innovation and securitization. These discussions could assist in banks' adoption of the most appropriate accounting policies.
70. Both banking supervisors and the accountancy profession have an interest in achieving uniformity among banks in their application of appropriate accounting policies. Banking supervisors are often able to exercise a persuasive influence over banks in achieving uniform policies because of their regulatory powers, while external auditors are often better placed to monitor or review the actual application of such policies. A continuing dialogue between supervisory agencies and the profession could therefore significantly contribute towards the harmonization of accounting standards for banks at the national level.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1005

THE SPECIAL CONSIDERATIONS IN THE AUDIT OF SMALL ENTITIES

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This International Auditing Practice Statement (IAPS) has been prepared by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC). It was approved by the IAPC in March 1999 for publication in March 1999.

The purpose of this IAPS is to provide practical assistance to auditors in applying International Standards on Auditing (ISAs) in the audit of financial statements of small entities. It does not affect the basic principles and essential procedures of ISAs.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where no PSP is added, the IAPS is applicable in all material respects to the public sector.

Introduction

1. International Standards on Auditing (ISAs) contain basic principles and essential procedures together with related guidance that apply to the audit of the financial statements of any entity, irrespective of its size, its legal form, ownership or management structure, or the nature of its activities. The IAPC recognizes that small entities give rise to a number of special audit considerations. This IAPS does not establish any new requirements for the audit of small entities; nor does it establish any exemptions from the requirements of ISAs. All audits of small entities are to be conducted in accordance with ISAs.
2. The objective of this IAPS is to describe the characteristics commonly found in small entities and indicate how they may affect the application of ISAs. This IAPS includes:
 - (a) Discussion of the characteristics of small entities;
 - (b) Guidance on the application of ISAs to the audit of small entities; and
 - (c) Guidance on the impact on the auditor's work where the auditor also provides accounting services to the small entity.
3. The provision of accounting services by auditors is prohibited by law in some jurisdictions. In others, the provision of accounting services by auditors is permitted both by law and professional ethics.¹ Section 3 of this IAPS deals with the special factors to be taken into account by auditors who also provide accounting services to small entities.
4. In determining the nature and extent of the guidance provided in this IAPS, the IAPC has aimed to provide a level of guidance that will be of general applicability to all audits of small entities and that will assist the auditor in exercising professional judgment with respect to the application of ISAs. However, detailed guidance of a procedural nature has not been provided, as the issue of such guidance may undermine the proper exercise of professional judgment in auditing.

THE CHARACTERISTICS OF SMALL ENTITIES

5. The auditor of any entity adapts the audit approach to the circumstances of the entity and the engagement. The audit of a small entity differs from the audit of a large entity as documentation may be unsophisticated, and audits of small entities are ordinarily less complex and may be performed using fewer assistants.
6. The meaning of "small entity" in this context gives consideration not only to the size of an entity but also to its typical qualitative characteristics. Quantitative indicators of the size of an entity may include balance sheets

¹ The IFAC Code of Ethics permits the provision of accounting and other services to audit clients, provided that independence is safeguarded.

totals, revenue and the number of employees, but such indicators are not definitive. Therefore it is not possible to give an adequate definition of a small entity solely in quantitative terms.

7. For the purposes of this IAPS, a small entity is any entity in which:
 - (a) There is concentration of ownership and management in a small number of individuals (often a single individual²); and
 - (b) One or more of the following are also found:
 - Few sources of income;
 - Unsophisticated record-keeping;
 - Limited internal controls together with the potential for management override of controls.
8. The qualitative characteristics described above are not exhaustive, they are not exclusive to small entities and small entities do not necessarily display all of those characteristics. For the purposes of this IAPS, small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

Concentration of Ownership and Management

9. Small business entities ordinarily have few owners; often there is a single proprietor. The owner may employ a manager to run the entity but is in most cases directly involved in running the entity on a day-to-day basis. Likewise, in the case of small not-for-profit organizations and public sector entities, although there are often several individuals charged with formal responsibility for the entity, there may be few people involved in managing the entity on a day-to-day basis.
10. This IAPS uses the term “owner-manager” to indicate the proprietors of entities who are involved in the running of the entity on a day-to-day basis. Where proprietors are not involved on a day-to-day basis, the term “owner-manager” is used to refer to both the proprietors, and to any managers hired to run the entity.

Few Sources of Income

11. Small entities often have a limited range of products or services and operate from a single or limited number of locations. Such characteristics may make it easier for the auditor to acquire, record, and maintain a knowledge of the entity than would be the case with a larger entity. The application of a wide range of audit procedures may be straightforward in such circumstances. For example, effective predictive models for use in analytical procedures can

² The word “individual” denotes ownership by a natural person, rather than by another entity. An entity owned by another enterprise may, however, be regarded as a “small entity” for the purpose of this IAPS if the owner exhibits the relevant characteristics.

sometimes be constructed. Analytical procedures may provide useful evidence, sometimes reducing the need for other substantive procedures. In addition, in many small entities, accounting populations are often small and easily analyzed.

Unsophisticated Record-Keeping

12. Small entities need to keep sufficient accounting records to comply with any relevant statutory or regulatory requirements and to meet the needs of the entity, including the preparation and audit of financial statements. Therefore, the accounting system needs to be designed in such a manner so as to provide reasonable assurance that:
 - (a) All the transactions and other accounting information that should have been recorded have in fact been recorded;
 - (b) Assets and liabilities recorded in the accounting system exist and are recorded at the correct amounts; and
 - (c) Fraud or error in processing accounting information will be detected.
13. Most small entities employ few, if any, personnel who are solely engaged in record-keeping. Consequently the bookkeeping functions and accounting records are often unsophisticated. Record keeping may be unsophisticated or poor, which results in a greater risk that the financial statements may be inaccurate or incomplete. Many small entities outsource some of or all their record keeping.
14. Small entities often find it convenient to use branded accounting software packages designed for use on a personal computer. Many of these packages have been widely tested and accredited and can, if chosen and implemented with care, provide a reasonable basis for a reliable and cost-effective accounting system.

Limited Internal Controls

15. Size and economic considerations in small entities mean that sophisticated internal controls are often neither necessary nor desirable, the fact that there are few employees limits the extent to which segregation of duties is practicable. However, for key areas, even in the very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. Supervisory controls exercised on a day-to-day basis by the owner-manager may also have a significant beneficial effect as the owner-manager has a personal interest in safeguarding the assets of the entity, measuring its performance and controlling its activities.
16. The owner-manager occupies a dominant position in a small entity. The owner-manager's direct control over all decisions, and the ability to intervene personally at any time to ensure an appropriate response to changing circumstances, are often important features of the management of small

entities. The exercise of this control can also compensate for otherwise weak internal control procedures. For example, in cases where there is limited segregation of duties in the area of purchasing and cash disbursements, internal control is improved when the owner-manager personally signs all checks. When the owner manager is not involved, there is a greater risk that employee fraud or error may occur and not be detected.

17. While a lack of sophistication in internal controls does not, of itself, indicate a high risk of fraud or error, an owner-manager's dominant position can be abused: management override of controls may have a significant adverse effect on the control environment in any entity, leading to an increased risk of management fraud or material misstatement in the financial statements. For example, the owner-manager may direct personnel to make disbursements that they would otherwise not make in the absence of supporting documentation.
18. The impact of the owner-manager and the potential for management override of internal controls on the audit depend to a great extent on the integrity, attitude, and motives of the owner-manager. As in any other audit, the auditor of a small entity exercises professional skepticism. The auditor neither assumes that the owner-manager is dishonest nor assumes unquestioned honesty. This is an important factor to be considered by the auditor when assessing audit risk, planning the nature and extent of audit work, evaluating audit evidence, and assessing the reliability of management representations.

COMMENTARY ON THE APPLICATION OF INTERNATIONAL STANDARDS ON AUDITING

19. The commentary that follows provides guidance on the application of ISAs to the audit of a small entity. This guidance is a supplement to, and not a substitute for, the guidance contained in the relevant ISA and takes account of the special considerations relevant to the audit of small entities. For the specific requirements of ISAs, the auditor refers to the ISA concerned. Where an ISA is, in principle, applicable to the audit of the financial statements of small entities and there are no special considerations applicable to the audit of a small entity, no guidance is given in respect of that ISA.

ISA 210: Terms of Audit Engagements

20. In many cases, owner-managers of small entities are not fully aware of their own responsibilities or those of their auditors. In particular, owner-managers may not appreciate that the financial statements are their responsibility, particularly where the owner-manager has outsourced the preparation of the financial statements. One of the purposes of an engagement letter is to communicate clearly the respective responsibilities of the owner-manager and the auditor. The Appendix to ISA 210 provides an example of an audit engagement letter.

21. In some cases the auditor may determine that it will not be possible to obtain sufficient evidence to form an opinion on the financial statements because of weaknesses that may arise from the characteristics of the small entity. In these circumstances, and where permitted by the relevant jurisdiction, the auditor may decide not to accept the engagement, or to withdraw from the engagement after acceptance. Alternatively, the auditor may decide to continue with the engagement but qualify or disclaim the audit opinion. The auditor has regard to paragraph 41 of ISA 700 “The Auditor’s Report on Financial Statements” which states that the auditor would not ordinarily accept an audit engagement in which the terms of the engagement are such that the auditor believes that the need to express a disclaimer of opinion exists.

ISA 220: Quality Control for Audit Work

22. The primary objective of quality control is to provide assurance that audits are conducted in accordance with generally accepted auditing standards. The auditor of a small entity keeps this objective in mind when determining the nature, timing, and extent of the policies and procedures appropriate to the circumstances.
23. Paragraph 5 of ISA 220 states: “The nature, timing and extent of an audit firm’s quality control policies and procedures depend on a number of factors such as the size and nature of the practice...” Many audits of small entities are undertaken by small audit firms. Such firms, in determining appropriate policies and procedures, consider the areas listed in paragraph 6 of ISA 220 which are:
 - (a) Professional requirements;
 - (b) Skills and competence;
 - (c) Assignment;
 - (d) Delegation;
 - (e) Consultation;
 - (f) Acceptance and retention of clients; and
 - (g) Monitoring.
24. With the possible exception of “assignment” and “delegation” (which may not be relevant to sole practitioners with no assistants), each of these will ordinarily be reflected in the arrangements established by firms auditing small entities.
25. The requirements of ISA 220 relating to quality control on individual audits are mostly relevant to engagements where some of the work is delegated to one or more assistants. Many small entity audits are carried out entirely by the audit engagement partner (who may be a sole practitioner). In such situations, questions of direction and supervision of assistants and review of their work

do not arise as the audit engagement partner, having personally conducted all significant aspects of the work, is aware of all material issues.

26. The audit engagement partner (or sole practitioner) nevertheless needs to be satisfied that the audit has been conducted in accordance with ISAs. Developing or obtaining a suitably designed form of audit completion checklist may provide a useful tool for testing the completeness and adequacy of the process followed in an audit. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performed the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor's professional body, on a confidential basis.

ISA 230: Documentation

27. The auditor may have an in-depth understanding of the entity and its business, because of the close relationship between the auditor and the owner-manager, or because of the size of the entity being audited, or the size of the audit team and the audit firm. However, that understanding does not eliminate the need for the auditor to maintain adequate working papers. Working papers assist in the planning, performance, supervision and review of the audit, and they record the evidence obtained to support the audit opinion.
28. The discipline imposed by the requirement to record the reasoning and conclusions on significant matters requiring the exercise of judgment can often, in practice, add to the clarity of the auditor's understanding of the issues in question and enhance the quality of the conclusions. This is so for all audits, even in the case of a sole practitioner with no assistants.
29. Different techniques may be used to document the entity's accounting and internal control systems, depending on their complexity. However in small entities the use of flowcharts or narrative descriptions of the system are often the most efficient techniques. These can be kept as permanent information and are reviewed and updated as necessary in subsequent years.
30. Paragraph 11 of ISA 230 provides examples of the contents of working papers. These examples are not intended to be used as a checklist of matters to be included in all cases. The auditor of a small entity uses judgment in determining the contents of working papers in any particular case.
31. Nevertheless, the auditor of a large or a small entity, records in the working papers:
 - (a) The audit planning;
 - (b) An audit program setting out the nature, timing, and extent of the audit procedures performed;
 - (c) The results of those procedures; and

- (d) The conclusions drawn from the audit evidence obtained together with the reasoning and conclusions on all significant matters requiring the exercise of judgment.

ISA 240: Fraud and Error³

32. Paragraphs 13 and 14 of ISA 240 illustrate certain conditions or events that may increase the risk of fraud or error. Examples of these conditions or events are given in Appendix 1 to the ISA. A relevant example applicable to small entities is “management is dominated by one person (or a small group) and there is no effective oversight board or committee...” Although this situation applies to most small entities, the guidance in ISA 240 is not intended to imply that all small entities are to be regarded by the auditor as necessarily involving a higher risk of fraud or error than larger entities.
33. The presence of a dominant owner-manager is an important factor in the overall control environment, as the need for management authorization can compensate for otherwise weak control procedures and reduce the risk of employee fraud and error. However, this can be a potential weakness since there is the opportunity for management override of controls. The owner-manager’s attitude to control issues in general and to the personal exercise of supervisory controls can have a significant influence on the auditor’s approach. The auditor’s assessment of the effect of such matters is conditioned by knowledge of that particular entity and the integrity of its owner-manager. Matters that auditors take into account in this assessment include the following.
- Whether the owner-manager has a specific identifiable motive (for example, dependence of the owner-manager on the success of the entity) to distort the financial statements, combined with the opportunity to do so.
 - Whether the owner-manager makes no distinction between personal and business transactions.
 - Whether the owner-manager’s life-style is materially inconsistent with the level of his or her remuneration (this includes other sources of income of which the auditor may be aware by completing the owner-manager’s tax return, for example).
 - Frequent changes of professional advisers.
 - Whether the start date for the audit has been repeatedly delayed or there are unexplained demands to complete the audit in an unreasonably short period of time.

³ Subsequent to the issue of this IAPS, ISA 240, “Fraud and Error” was replaced by ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements,” which is effective for audits of financial statements for periods ending on or after June 30, 2002. Earlier application is permissible.

- Unusual transactions around the year-end that have a material effect on profit.
- Unusual related party transactions.
- Payments of fees or commissions to agents and consultants that appear excessive.
- Disputes with tax authorities.

ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

34. ISA 250 requires the auditor to obtain a general understanding of the legal and regulatory framework to which the entity is subject. Apart from those laws and regulations that relate directly to the preparation of the financial statements, there may also be laws and regulations that provide a legal framework for the conduct of the entity and that are central to the entity's ability to conduct its business. As most small entities have uncomplicated activities, the legal and regulatory environment to which they are subject is less complicated than the environment in which larger more diversified entities operate.
35. Once the auditor of a small entity has identified any relevant industry-specific laws and regulations, this information is recorded as permanent information as part of the knowledge of the entity and is reviewed and updated as necessary in subsequent years.

ISA 300: Planning

36. Audits of small entities are conducted by very small audit teams, many involve the audit engagement partner (or sole practitioner) working with one audit assistant (or without audit assistants). With a smaller team, co-ordination and communication between team members is easier. Planning the audit of a small entity need not be a complex or time-consuming exercise, it varies according to the size of the entity and the complexity of the audit. For example, on some small audits, planning may be carried out at a meeting with the owner-manager of the entity or when the entity's records become available to the auditor for audit. Planning the audit can, however, start at the completion of the previous period's audit as the auditor will be well placed to plan for the next period. A brief file note prepared at this time, based on a review of the working papers and highlighting issues identified in the audit just completed can be particularly helpful. This file note, amended for changes arising during the subsequent period, could then be the initial basis for planning the next audit. Discussion with the owner-manager is a very important part of planning, especially in a first-year audit. Such discussions do not need a special meeting they can often take place as a part of other meetings, conversations or correspondence.
37. In principle, planning comprises developing a general strategy (reflected in an overall audit plan) and a detailed approach for implementing the strategy in

terms of the nature, timing and extent of the audit work (reflected in an audit program). However, a practical approach to the audit of a small entity need not involve excessive documentation. In the case of a small entity where, because of the size or nature of the entity, the details of the overall plan can be adequately documented in the audit program, or vice versa, separate documentation of each may not be necessary. When standard audit programs are used, these are appropriately modified and tailored to the particular client circumstances.

ISA 310: Knowledge of the Business

38. The Appendix to ISA 310 gives a list of matters that the auditor may consider in relation to knowledge of the business. This list is illustrative only, it is not exhaustive, nor are all the matters listed relevant to every audit. In particular, the auditor of a small entity will often find that many of the points in this list are simply not relevant. It would therefore be inappropriate to regard this Appendix as a form of checklist to be applied routinely in all audits. It may, however, be sufficient for the auditor to use a checklist that has been appropriately tailored to the particular small entity; such a checklist can be reviewed and updated in subsequent years.
39. The auditor of a small entity is often in a position to have a wide and up-to-date knowledge of the business by virtue of the fact that there may be regular close contact with the owner-manager. This relationship often provides information on matters such as the following.
 - The activities of the small entity, its main products and services, and the industry in which it operates.
 - The management style, aims, and attitudes of the owner-manager.
 - Any plans for changes to the nature, management or ownership of the entity.
 - Trends in profitability or liquidity and the adequacy of working capital.
 - Legal or regulatory issues facing the entity, including its relationship with the taxation authorities.
 - The accounting records.
 - The control environment.
40. Documenting the auditor's knowledge of the business is equally important in all audits, irrespective of the size of the entity. However, the extent of the documentation depends on the complexity of the entity and the number of persons who will be engaged on the audit. Small entities are ordinarily not complex and their audit rarely involves large teams of assistants. In many cases the audit may be performed by the partner and, perhaps, a single assistant. Therefore, whilst the auditor of a small entity will prepare documentation to a level sufficient to:

- (a) Facilitate proper planning of the audit; and
- (b) Provide for any change of responsibility within the audit firm, such as changes of audit engagement partner or the departure, illness or incapacity of assistants.

Such documentation will ordinarily be unsophisticated in format and as brief as circumstances allow.

ISA 320: Audit Materiality

41. “Materiality” is defined in the International Accounting Standards Committee’s “Framework for the Preparation and Presentation of Financial Statements” as follows: “Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful”.

Planning Stage

42. For audit planning purposes, it is generally necessary to assess materiality from a qualitative and quantitative perspective. One purpose of this preliminary judgment about materiality is to focus the auditor’s attention on the more significant financial statement items while determining the audit strategy. As there are no authoritative pronouncements on how materiality is assessed in quantitative terms, the auditor in each case applies professional judgment in the light of the circumstances. One approach to the assessment of quantitative materiality is to use a percentage of a key figure in the financial statements such as one of the following.
- Profit or loss before tax (adjusted, if appropriate, for the effect of any abnormal levels of items of expenditure such as the owner-manager’s remuneration).
 - Revenue.
 - Balance sheet total.
43. Often in the case of small entities, draft financial statements are not available to the auditor at the commencement of the audit. When this is the case, the auditor uses the best information available at the time. The current year’s trial balance may be used, if available. Often an estimate of revenue for the current period can be more readily obtained than of profit (or loss) or of a balance sheet total. A common approach in the preliminary judgment of materiality is to calculate materiality on the previous year’s audited financial statements as amended for known circumstances in relation to the year subject to audit.

44. Assessing materiality as a percentage of pre-tax results may be inappropriate when the entity is at or near the break-even point as it may give an inappropriately low level of materiality, leading to unnecessarily extensive audit procedures. In such cases, the auditor may apply the percentage method to, for example, revenue or balance sheet totals. Alternatively, materiality may be assessed having regard to assessed levels of materiality in prior years and the normal level of results. In addition to considering materiality at the overall financial statement level, the auditor considers materiality in relation to individual account balances, classes of transactions, and disclosures.

Assessment of Materiality when Evaluating the Results of Audit Procedures

45. Whatever basis may be used to assess materiality for audit planning purposes, the auditor reassesses materiality when evaluating the results of audit procedures. This reassessment takes account of the final version of the draft financial statements, incorporating all agreed adjustments and information obtained during the course of the audit.
46. Although materiality at the reporting stage is considered in quantitative terms, there is no clear threshold value but rather a range of values within which the auditor exercises judgment. Amounts above the upper limit of the range may be presumed material and amounts below the lower limit may be presumed not material, although either presumption may be rebutted by applying qualitative considerations.
47. In addition, although planning may have been based on a quantitative assessment of materiality, the auditor's opinion will take into account not only the amount but also the qualitative nature of unadjusted misstatements within the financial statements.

ISA 400: Risk Assessments and Internal Control

Inherent Risk

48. In the audit of a small entity, control risk is often assumed or assessed as high, at least for certain financial statement assertions. The assessment of inherent risk for those assertions takes on a particular significance, as it has a direct impact on the extent of substantive procedures. There are difficulties in the assessment of the inherent risk of a small entity, for example there may be increased risk as a result of the concentration of ownership and control. However, the auditor's assessment of inherent risk in a small entity depends on its particular characteristics. A careful assessment of inherent risk for material financial statement assertions, rather than an assumption that it is high, may enable the auditor to conduct a more efficient and effective audit.

Control Risk

49. An understanding of the control environment is essential to the understanding of control risk. The auditor considers the overall influence of the owner-

manager and other key personnel. For example, the auditor considers whether the owner-manager displays a positive control consciousness and considers the extent to which the owner-manager and other key personnel are actively involved in day-to-day operations.

50. After obtaining an understanding of the accounting and internal control systems, the auditor makes a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions. Substantive procedures may be reduced if reliance on these controls is warranted after investigation and testing. However, many internal controls relevant to large entities are not practical in the small entity, and as a result it may not be possible to rely on internal control to detect fraud or errors. For example, segregation of duties may be severely limited in small entities because accounting procedures may be performed by few persons who may have both operating and custodial responsibilities. Similarly, when there are few employees, it may not be possible to set up a system of independent checking of their work.
51. Inadequate segregation of duties and the risk of error may, in some cases, be offset by other control procedures such as the exercise of strong supervisory controls by the owner-manager means of direct personal knowledge of the entity and involvement in transactions. However this, in itself, may introduce other risks such as the potential for management override and fraud. Particular difficulties include the possible understatement of income by the non-recording or misrecording of sales. In circumstances where segregation of duties is limited and evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures.
52. The auditor of a small entity may decide, based on the auditor's understanding of the accounting system and control environment, to assume that control risk is high without planning or performing any detailed procedures (such as tests of controls) to support that assessment. Even where there appear to be effective controls it may be more efficient for the auditor to confine audit procedures to those of a substantive nature.
53. The auditor makes management aware of material weaknesses in the design or operation of the accounting and internal control systems that have come to the auditor's attention. Recommendations for improvement may also be made in this communication. Such recommendations are particularly valuable for the development of the small entity's accounting and internal control systems.

Detection Risk

54. The auditor uses the assessments of inherent and control risk to determine the substantive procedures that will provide the audit evidence to reduce detection risk, and therefore audit risk, to an acceptable level. In some small entities, such as those where most transactions are for cash and there is no regular

pattern of costs and margins, the available evidence may be inadequate to support an unqualified opinion on the financial statements.

ISA 401: Auditing in a Computer Information Systems Environment

55. The increasing availability of computer-based accounting systems that are capable of meeting both functional and economic circumstances of even the smallest entity impacts on the audits of those entities. Small entities' accounting systems often make use of personal computers. International Auditing Practice Statement 1001, "CIS Environments—Stand-Alone Microcomputers" gives additional guidance regarding the special considerations of such an environment.
56. Small entities are likely to use less sophisticated hardware and software packages than large entities (often "packaged" rather than developed "in house"). Nevertheless, the auditor has sufficient knowledge of the computer information system to plan, direct, supervise, and review the work performed. The auditor may consider whether specialized skills are needed in an audit.
57. Because of the limited segregation of duties, the use of computer facilities by a small entity may have the effect of increasing control risk. For example, it is common for users to be able to perform two or more of the following functions in the accounting system.
 - Initiating and authorizing source documents.
 - Entering data into the system.
 - Operating the computer.
 - Changing programs and data files.
 - Using or distributing output.
 - Modifying the operating systems.
58. The use of computer information systems by small entities may assist the auditor in obtaining assurance as to the accuracy and appropriateness of accounting records by reducing control risk. Computerized information systems may be better organized, less dependent upon the skills of people using them, and less susceptible to manipulation than non-computerized systems. The ability of the auditor to obtain relevant reports and other information may also be enhanced. Good computerized systems facilitate accurate double entry and the reconciliation of subsidiary ledgers with control accounts. Report generation and the production of bank reconciliations may be more disciplined and effective, and the availability of reports and other information to the auditor is often improved. The assurance provided by such features, providing they are properly evaluated and tested, may permit the auditor limit the volume of substantive testing of transactions and balances.
59. The general principles outlined in International Auditing Practice Statement 1009 "Computer-Assisted Audit Techniques" (CAATs) are also applicable in

small entity computer environments and give additional guidance regarding the special considerations in such an environment. However, in many cases where smaller volumes of data are processed, manual methods may be more cost-effective.

ISA 500: Audit Evidence

60. ISA 500 recognizes that, although audit evidence may be obtained in a number of ways, including from an appropriate mix of tests of control and substantive procedures, in some circumstances evidence may be obtained entirely from substantive procedures. A typical example of such circumstances would be where segregation of duties is limited and evidence of supervisory control is lacking, as is the case in many small entities.
61. In the audit of small entities, there are particular problems in obtaining audit evidence to support the assertion of completeness. There are two principal reasons for this:
 - (a) The owner-manager occupies a dominant position and may be able to ensure that some transactions are not recorded; and
 - (b) The entity may not have internal control procedures that provide documentary evidence that all transactions are recorded.
62. The auditor plans and conducts the audit with an attitude of professional skepticism. In the absence of evidence to the contrary, the auditor is entitled to accept representations as truthful and records as genuine.
63. The auditor of a small entity need not assume that there will be limited internal controls over the completeness of important populations such as revenue. Many small entities have some form of numerically based system to control the dispatch of goods or the provision of services. Where there is such a system to ensure completeness, the auditor may obtain audit evidence of its operation, by means of tests of control, to assist in determining whether control risk can be assessed at less than high in order to justify a reduction in the extent of substantive testing.
64. Where there are no internal controls relevant to the assertion, the auditor may be able to obtain sufficient evidence from substantive procedures alone. Such procedures may include the following.
 - Comparing recorded amounts with amounts calculated on the basis of separately recorded data, for example, goods issues recorded in physical stock records may be expected to give rise to sales income, and job sheets or time records may be expected to give rise to charges to clients.
 - Reconciling total quantities of goods bought and sold.
 - Analytical procedures.
 - External confirmation.

- A Review of transactions after the balance sheet date.

ISA 520: Analytical Procedures

Analytical Procedures in Planning the Audit

65. The auditor applies analytical procedures at the planning stage of the audit. The nature and extent of analytical procedures at the planning stage of the audit of a small entity may be limited by the timeliness of processing of transactions by the small entity and the lack of reliable financial information at that point in time. Small entities may not have interim or monthly financial information that can be used in analytical procedures at the planning stage. The auditor may, as an alternative, conduct a brief review of the general ledger or such other accounting records as may be readily available. In many cases, there may be no documented information that can be used for this purpose, and the auditor may obtain the required information through discussion with the owner-manager.

Analytical Procedures as Substantive Procedures

66. Analytical procedures can often be a cost-effective means of obtaining evidence required by the auditor. The auditor assesses the controls over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures.
67. An unsophisticated predictive model can sometimes be effective. For example, where a small entity has employed a known number of staff at fixed rates of pay throughout the period, it will ordinarily be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in analytical procedures to provide evidence to support the reasonableness of recorded items. The extent of analytical procedures in the audit of a small entity may be limited because of the non-availability of information on which the analytical procedures are based.
68. Predictive analytical procedures can often be an effective means of testing for completeness, provided the results can be predicted with a reasonable degree of precision and confidence. Variations from expected results may indicate possible omissions that have not been detected by other substantive tests.
69. However, different types of analytical procedure provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can be a very persuasive source of evidence and may eliminate the need for further

verification by means of tests of details. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may be a less persuasive source of evidence, but may provide useful corroboration if used in combination with other audit procedures.

Analytical Procedures as Part of the Overall Review

70. The analytical procedures ordinarily performed at this stage of the audit are very similar to those that would be used at the planning stage of the audit. These include the following.
- Comparing the financial statements for the current year to those of previous years.
 - Comparing the financial statements to any budgets, forecasts, or management expectations.
 - Reviewing trends in any important financial statement ratios.
 - Considering whether the financial statements adequately reflect any changes in the entity of which the auditor is aware.
 - Inquiring into unexplained or unexpected features of the financial statements.

ISA 530: Audit Sampling and Other Selective Testing Procedures

71. There are a variety of methods of selecting items for testing, the auditor's choice of an appropriate method will be guided by considerations of effectiveness and efficiency. The means available to the auditor are:
- (a) Selecting all items (100% examination);
 - (b) Selecting specific items; or
 - (c) Audit sampling.
72. The small populations ordinarily encountered in small entities may make it feasible to test:
- (a) 100% of the population; or
 - (b) 100% of some part of the population, for example, all items above a given amount, applying analytical procedures to the balance of the population, if it is material.
73. When the above methods of obtaining audit evidence are not adopted, the auditor considers the use of procedures involving audit sampling. When the auditor decides to use audit sampling, the same underlying principles apply in both large and small entities. The auditor selects sample items in such a way that the sample can be expected to be representative of the population.

ISA 550: Related Parties

74. Significant transactions are often entered into between the small entity and the owner-manager, or between the small entity and entities related to the owner-manager. Small entities seldom have sophisticated policies and codes of conduct on related party transactions. Indeed, related party transactions are a regular feature of many entities that are owned and managed by an individual or by a family. Further, the owner-manager may not fully understand the definition of a related party, especially where relevant accounting standards deem certain relationships to be related and others not. The provision of management representations in respect of the completeness of disclosure may entail some explanation by the auditor of the technical definition of a related party.
75. The auditor of a small entity ordinarily performs substantive procedures on the identification of related parties and related party transactions. However, if the auditor assesses the risk of undisclosed related party transactions as low, such substantive procedures need not be extensive. The auditor often acts as the auditor of other entities related to the small entity, which may assist in identifying related parties.
76. The auditor's in-depth knowledge of the small entity may be of assistance in the identification of related parties, which in many instances, will be with entities controlled by the owner-manager. This knowledge can also help the auditor assess whether related party transactions might have taken place without recognition in the entity's accounting records.

ISA 560: Subsequent Events*Subsequent Events Between the Period end and the Date of the Auditor's Report*

77. It is not common for small entities to be required to report shortly after their period-end. It is often the case that more time elapses between the period end and the approval or signature of the financial statements by the owner-manager in the case of small entities, than in the case of large entities. The period to be covered by the auditor's subsequent events procedures is therefore often longer in the audit of a small entity, allowing more opportunity for the occurrence of subsequent events that can affect the financial statements. ISA 560 requires the auditor to perform procedures to cover the entire period from the period-end up to the date of the audit report.
78. The subsequent events procedures that the auditor of a small entity performs will depend on the information that is available and, in particular, the extent to which the accounting records have been written up since the period-end. When the accounting records are not up-to-date and minutes of meetings of the directors have not been prepared, relevant procedures can take the form of inquiry of the owner-manager, recording the owner-manager's responses and inspection of bank statements. Paragraph 5 of ISA 560 gives examples of

some of the matters that it may be appropriate for the auditor to consider in the course of these inquiries.

79. The auditor may, depending on the circumstances, consider that the letter of representation should cover subsequent events. The letter of representation is ordinarily dated on the same day as the audit report, thus covering the entire period since the period end.
80. Guidance on the auditor's procedures relating to subsequent events (if any) in the period between the approval of the financial statements and the date of the auditor's report is given in the guidance provided in this IAPS on ISA 700 "The Auditor's Report on Financial Statements."

Subsequent Events Between the Date of the Auditor's Report and the Financial Statements Being Issued

81. Where, as in many small entities, the meeting at which the financial statements are approved or signed is immediately followed by the annual general meeting, the interval between the two does not require any separate consideration by the auditor as it is so short.
82. If the auditor becomes aware of a fact that materially affects the financial statements, the auditor considers whether the financial statements require amendment, discusses the matter with management, and takes action appropriate in the circumstances.

ISA 570: Going Concern⁴

83. The size of an entity affects its ability to withstand adverse conditions. Small entities can respond quickly to exploit opportunities, but their lack of reserves limits their ability to sustain operations.
84. ISA 570 requires that auditors consider the risk that the going concern assumption may not be appropriate. Risk factors of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, the risk of the loss of a major customer or key employee, and the risk of the loss of the right to operate under a license, franchise or other legal agreement.
85. ISA 570 gives guidance on the evidence to be obtained when a question arises as to the appropriateness of the going concern basis. Such evidence may include a review of documentation such as budgets, cash flow and profit forecasts. In the audit of a small entity, the auditor does not ordinarily expect to find detailed budgets and forecasts relevant to the consideration of going concern. Nevertheless, the auditor discusses with the owner-manager the going concern status of the entity and in particular, the financing of the entity in the medium and long-term. The auditor considers these discussions in the

⁴ ISA 570, "Going Concern" was revised subsequent to the issue of this IAPS. The revised ISA 570 is effective for audits of financial statements for periods ending on or after December 31, 2000.

light of corroborative documentation and the auditor's knowledge of the business. The auditor considers the need to obtain written management representations.

86. Where the small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating his loan to the entity in favor of banks or other financial institutions. In such circumstances the auditor inspects appropriate, documentary evidence of the subordination of the owner-manager's loan. Where an entity is dependent on additional support from the owner-manager, the auditor considers the owner-manager's ability to meet the obligation under the support arrangement. In addition, the auditor may ask for a written representation confirming the owner-manager's intention or understanding.

ISA 580: Management Representations

87. Paragraph 6 of ISA 580 states that, when representations relate to matters that are material to the financial statements, the auditor:
 - (a) Seeks corroborative audit evidence from sources inside or outside the entity;
 - (b) Evaluates whether the representations made by management appear reasonable and are consistent with other audit evidence obtained, including other representations; and
 - (c) Considers whether the individuals making the representations can be expected to be well-informed on the particular matters.
88. Paragraph 7 of ISA 580 states that representations from management cannot be a substitute for other audit evidence that the auditor expects to be available. If such audit evidence cannot be obtained, this may constitute a limitation on the scope of the audit and the auditor considers the implications for the audit report. However, in certain instances, a representation by management may be the only audit evidence that the auditor can reasonably expect to be available.
89. In view of the particular characteristics of small entities, the auditor may judge it appropriate to obtain written representations from the owner-manager as to the completeness and accuracy of the accounting records and of the financial statements (for example, that all income has been recorded). Such representations, on their own, do not provide sufficient audit evidence. The auditor assesses the representations in conjunction with the results of other relevant audit procedures, the auditor's knowledge of the business and of its owner-manager, and considers whether, in the particular circumstances, it would be reasonable to expect other audit evidence to be available. The possibility of misunderstandings between the auditor and the owner-manager is reduced when oral representations are confirmed by the owner-manager in writing.

ISA 700: The Auditor's Report on Financial Statements⁵

90. The objective of any audit is for the auditor to obtain sufficient appropriate audit evidence to be able to express an opinion on the financial statements. In many cases the auditor will be able to express an unqualified opinion on the financial statements of small entities. However there may be circumstances that necessitate a modification of the auditor's report.

Scope Limitations

91. When the auditor is unable to design or carry out procedures to obtain sufficient appropriate audit evidence as to the completeness of accounting records, this may constitute a limitation in the scope of the auditor's work. The limitation would lead to a qualification of the opinion or, in circumstances where the possible effects of the limitation are so significant that the auditor is unable to express an opinion on the financial statements, a disclaimer of opinion.
92. The following illustrative paragraphs may be used for this purpose.

Example of paragraphs for an auditor's report qualified when completeness of accounting records is not substantiated—scope limitation that does not prevent the auditor from expressing an opinion.

The company's recorded sales include \$X in respect of cash sales. There was no system of control over such sales on which we could rely for the purpose of our audit and there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales were properly recorded.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the completeness and accuracy of the accounting records in respect of sales, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the company as of...and the results of its operations and its cash flows for the year then ended in accordance with...(and comply with...).

Example of paragraphs for an auditor's report with disclaimer of opinion when completeness of accounting records is not substantiated—scope limitation that is so significant that the auditor is unable to express an opinion.

The company's sales were made entirely on a cash basis. There was no system of control over such sales on which we could rely for the purpose of our audit

⁵ ISA 700, "The Auditor's Report on Financial Statements" was revised subsequent to the issue of this IAPS. The revised ISA 700 is effective for audits of financial statements for periods ending on or after September 30, 2002. Earlier application is encouraged.

and there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales were properly recorded.

Because of the significance of the matter discussed in the preceding paragraph, we do not express an opinion on the financial statements.

Date and Signature of the Auditor's Report

93. The auditor dates the audit report as of the completion date of the audit. This date should not be earlier than the date on which the owner-manager approves or signs the financial statements. Approval may be in the form of a management representation. In the audit of small entities, for practical reasons, the auditor may actually sign the report on a date later than that on which the owner-manager approves or signs the financial statements. Prior planning by the auditor, and discussion with the management of their procedures for finalizing the financial statements will often prevent this situation from arising. Where it cannot be avoided, there is a possibility that some event during the intervening period could materially affect the financial statements. Therefore, the auditor takes such steps as are appropriate:
 - (a) To obtain assurance that, on that later date, the owner-manager would have acknowledged responsibility for the financial statements or the items appearing therein; and
 - (b) To ensure that their procedures for reviewing subsequent events cover the period up to that date.

ISA 720: Other Information in Documents Containing Audited Financial Statements

94. The auditor reads the other information to identify material inconsistencies with the audited financial statements. Examples of “other information” often included with the financial statements of a small entity are the detailed income and expenditure statement, that is often attached with audited financial statements for taxation purposes, and the management report.

THE PROVISION OF ACCOUNTING SERVICES TO THE SMALL ENTITY BEING AUDITED

95. This section is relevant to jurisdictions in which auditors are legally and professionally permitted to provide accounting services to their audit clients.
96. In some jurisdictions, auditors are permitted to provide accounting and other services to audit clients. The owner-manager of a small entity often needs assistance with the preparation of the financial statements, and other accounting services, and may seek such assistance from the auditor.
97. Examples of accounting services that the auditor may be engaged to perform include the following.

- Assisting with the keeping of accounting records.
 - Advising on the selection and application of accounting policies.
 - Assisting with the preparation of financial statements.
98. In performing accounting services, the auditor may obtain useful information about the entity and its owner-manager's aims, management style, and ethos. The auditor also acquires an in-depth knowledge of the entity, which assists in planning and conducting the audit. The auditor nevertheless remembers that assistance provided to the entity does not relieve the auditor from obtaining sufficient and appropriate audit evidence.

Ethical Considerations

99. The auditor bears in mind the overriding ethical requirement for independence and objectivity when forming and expressing an opinion on the financial statements and exercises care to ensure that the relationship with the entity does not prejudice the ability to form an objective opinion.
100. Paragraph 8.5 of the IFAC Code of Professional Ethics for Public Accountants permits the provision of other services, but states:
- “When a professional accountant in public practice, in addition to carrying out an audit or other reporting function, provides other services to a client, care should be taken not to perform management functions or make management decisions, responsibility for which remains with the board of directors and management.”
101. The commentary on paragraph 8.5 states that the provision of other services does not mean that the professional accountant has ceased to be independent. However, with respect to the preparation of accounting records, the commentary provides further advice as follows:
- “The preparation of accounting records is a service which is frequently requested of a professional accountant in public practice, particularly by smaller clients, whose businesses are not sufficiently large to employ an adequate internal accounting staff...In all cases in which independence is required and in which a professional accountant in public practice is concerned in the preparation of accounting records for a client, the following requirements should be observed:
- (a) The professional accountant in public practice should not have any relationship or combination of relationships with the client or any conflict of interest which would impair integrity or independence.
 - (b) The client should accept responsibility for the statements.
 - (c) The professional accountant in public practice should not assume the role of employee or of management conducting the operations of an entity.

- (d) Staff assigned to the preparation of accounting records ideally should not participate in the examination of such records. The fact that the professional accountant in public practice has processed or maintained certain records does not eliminate the need to make sufficient audit tests.”

COMMENTARY ON THE APPLICATION OF INTERNATIONAL STANDARDS ON AUDITING WHEN THE AUDITOR ALSO PROVIDES ACCOUNTING SERVICES TO THE SMALL ENTITY

Where the auditor provides accounting services to the small entity, the following additional matters may be relevant in the application of the ISAs by the auditor.

ISA 210: Terms of Audit Engagements

102. Where the auditor has assisted with the preparation of the financial statements, owner-managers of small entities may not be fully aware of their own legal responsibilities or those of the auditor. Owner-managers may not appreciate that the financial statements are their responsibility, or that the audit of the financial statements is legally quite distinct from any accounting services that the auditor provides. One of the purposes of an engagement letter is to avoid any such misunderstandings.
103. Paragraph 3 of ISA 210 states that the auditor may agree terms of engagement for other services by means of separate letters of engagement. However, there is no requirement for separate letters and, in the case of a small entity, there may be practical reasons why a single combined letter may be more appropriate.

ISA 230: Documentation

104. When the auditor provides accounting services to a small entity, such services are not audit work and so the requirements of ISA 230 do not ordinarily apply to, for example, documentation of the work done in assisting with the preparation of the financial statements.
105. A consideration when establishing a retention policy for the working papers of a small entity is that owner-managers often request copies of the working papers containing accounting information to assist them in the administration of their entity. Paragraph 14 of ISA 230 states that working papers are the property of the auditor. Although portions of, or extracts from, the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity’s accounting records. It may be helpful for the engagement letter to set out these requirements regarding the accounting records.

ISA 240: Fraud and Error⁶

106. The auditor may have obtained knowledge of the owner-manager's personal financial position and lifestyle through the provision of other services to the entity or the owner manager. This knowledge may enhance the quality of the auditor's assessment of the inherent risk of fraud. Unexplained demands to prepare the financial statements and complete the audit in an unreasonably short period of time may indicate that there is a increased risk of fraud or error occurring.

ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

107. Most entities are subject to requirements relating directly to the preparation of financial statements, including the relevant companies legislation. The accounting expertise of the auditor as regards the legislation relating to the preparation of the financial statements helps the owner-manager ensure that the relevant statutory obligations have been complied with.

ISA 300: Planning

108. When the auditor assists in the preparation of the financial statements, sufficient flexibility is required in the overall audit plan to take account of any areas of audit risk identified, and evidence obtained in performing those services. The auditor of a small entity therefore plans to take into consideration knowledge obtained from the accounting services so that the approach to obtaining evidence is properly co-ordinated and that efficiency of work and cost can be secured.

ISA 400: Risk Assessments and Internal Control

109. In performing accounting services, the auditor may obtain an understanding of the accounting and internal control system. This may indicate that there are certain internal controls that the auditor may wish to assess and test, which may in turn affect the nature, timing and extent of substantive procedures required for the audit.

ISA 500: Audit Evidence

110. The auditor of a small entity when providing accounting services, applies professional judgment in considering whether the other services rendered result in a reduction in the audit work necessary to support the auditor's opinion. Accounting services will seldom provide all, and may not even provide any, of the audit evidence required by the auditor. In particular, accounting services will ordinarily do no more than provide *some* of the necessary evidence regarding the completeness of a population, or the value at

⁶ See footnote 1.

which items are stated in the financial statements. However, audit evidence can often be obtained at the same time that the accounting work is done. Specific audit work will ordinarily be required, for example, on the recoverability of debtors, the valuation and ownership of inventories, the carrying value of fixed assets and investments and the completeness of creditors.

ISA 520: Analytical procedures

111. In small entities where the auditor has been engaged to perform accounting services, analytical procedures carried out at the planning stage of the audit will be more effective if some of the accounting services to be performed by the auditor have been completed before the audit planning is finalized.

ISA 540: Audit of Accounting Estimates

112. Although the owner-manager is responsible for determining the amount of the estimate to be included in the financial statements, the auditor of a small entity is often asked to assist with or advise on the preparation of any accounting estimates. By assisting with the process of preparing the accounting estimate, the auditor at the same time gains evidence relevant to meeting the requirements of ISA 540. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the reasonableness and appropriateness of the underlying assumptions used in arriving at the estimates.

ISA 550: Related parties

113. When assessing the risk of undisclosed related party transactions, the auditor takes account of any related party matters arising when providing any assistance on matters such as the following.
- Keeping the accounting records.
 - Preparing the financial statements (in particular any statutory disclosures required concerning loans and other transactions with directors and connected persons).
 - Personal and corporate tax matters.
 - Compiling and reviewing owner-manager's current accounts.
114. This, taken together with information obtained through discussion with the owner-manager, assists in the assessment of the risk in this area and may provide a reasonable basis for the risk to be assessed as low.
115. This assistance and the close relationship between the auditor and the owner-manager can assist in the identification of related parties, which, in most instances, will be with entities controlled by the owner-manager.

ISA 570: Going Concern⁷

116. In some small entities, the auditor may be asked to assist the owner-manager with the assessment of going concern and sometimes with the preparation of any necessary budgets or forecasts. In all cases, the owner-manager remains responsible for the assessment of going concern for any information prepared (even if the auditor assisted in its compilation), and for the reasonableness of the assumptions on which it is based. In such circumstances, the auditor takes appropriate steps to obtain the owner-manager's agreement, and acknowledgment of responsibility.

ISA 580: Management Representations

117. In the audit of a small entity, it is particularly important for the auditor to obtain management representations in which the owner-manager acknowledges responsibility for the fair presentation of the financial statements. This is particularly necessary where the auditor has assisted in drafting the financial statements, because of the danger of the auditor's role and responsibility in relation to the financial statements being misunderstood. In order to ensure that the representations are meaningful, the auditor considers explaining these matters to management before the representations are obtained.

⁷ See footnote 2.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1006

AUDITS OF THE FINANCIAL STATEMENTS OF BANKS

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International Auditing Practices Statements (Statements) are issued by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants to provide practical assistance to auditors in implementing the International Standards on Auditing (ISAs) or to promote good practice. Statements do not have the authority of ISAs.

This Statement has been prepared by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants. The IAPC bank audit sub-committee included observers from the Basel Committee on Banking Supervision (the Basle Committee).^{*} The document was approved for publication by the IAPC at its meeting in October 2001. It is based on ISAs extant at 1 October 2001.

This Statement does not establish any new basic principles or essential procedures; its purpose is to assist auditors, and to develop good practice, by providing guidance on the application of the ISAs to the audits of the financial statements of banks. The auditor exercises professional judgment to determine the extent to which any of the audit procedures described in this Statement may be appropriate in the light of the requirements of the ISAs and the bank's particular circumstances.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where no PSP is added, the IAPS is applicable in all material respects to the public sector.

^{*} The Basel Committee on Banking Supervision is a committee of banking and supervisory authorities that was established by the central bank governors of ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent secretariat is located.

Introduction

1. The purpose of this Statement is to provide practical assistance to auditors and to promote good practice in applying International Standards on Auditing (ISAs) to the audit of banks' financial statements. It is not, however, intended to be an exhaustive listing of the procedures and practices to be used in such an audit. In conducting an audit in accordance with ISAs the auditor complies with all the requirements of all the ISAs.
2. In many countries, banking supervisors require that the auditor report certain events to the regulators or make regular reports to them in addition to the audit report on the banks' financial statements. This Statement does not deal with such reports, the requirements for which often vary significantly between countries. IAPS 1004, "The Relationship Between Banking Supervisors and Bank's External Auditors" discusses that subject in more detail.
3. For the purpose of this Statement, a bank is a type of financial institution whose principal activity is the taking of deposits and borrowing for the purpose of lending and investing and that is recognized as a bank by the regulatory authorities in any countries in which it operates. There are a number of other types of entity that carry out similar functions, for example, building societies, credit unions, friendly societies, savings and loan associations and thrift institutions. The guidance in this Statement is applicable to audits of financial statements that cover the banking activities carried out by those entities. It also applies to the audits of consolidated financial statements that include the results of banking activities carried out by any group member. This Statement addresses the assertions made in respect of banking activities in the entity's financial statements and so indicates which assertions in a bank's financial statements cause particular difficulties and why they do so. This necessitates an approach based on the elements of the financial statements. However, when obtaining audit evidence to support the financial statement assertions, the auditor often carries out procedures based on the types of activities the entity carries out and the way in which those activities affect the financial statement assertions.
4. Banks commonly undertake a wide range of activities. However, most banks continue to have in common the basic activities of deposit taking, borrowing, lending, settlement, trading and treasury operations. This Statement's primary purpose is the provision of guidance on the audit implications of such activities. In addition, this Statement provides limited guidance in respect of securities underwriting and brokerage, and asset management, which are activities that auditors of banks' financial statements frequently encounter. Banks typically undertake activities involving derivative financial instruments. This Statement gives guidance on the audit implications of such activities when they are part of the bank's trading and treasury operations. IAPS 1012, "Auditing Derivative Financial Instruments" gives guidance on such activities when the bank holds derivatives as an end user.

5. This Statement is intended to highlight those risks that are unique to banking activities. There are many audit-related matters that banks share with other commercial entities. The auditor is expected to have a sufficient understanding of such matters and so, although those matters may affect the audit approach or may have a material effect on the bank's financial statements, this Statement does not discuss them. This Statement describes in general terms aspects of banking operations with which an auditor becomes familiar before undertaking the audit of a bank's financial statements: it is not intended to describe banking operations. Consequently, this Statement on its own does not provide an auditor with sufficient background knowledge to undertake the audit of a bank's financial statements. However, it does point out areas where that background knowledge is required. Auditors will supplement the guidance in this Statement with appropriate reference material and by reference to the work of experts as required.
6. Banks have the following characteristics that generally distinguish them from most other commercial enterprises:
 - They have custody of large amounts of monetary items, including cash and negotiable instruments, whose physical security has to be safeguarded during transfer and while being stored. They also have custody and control of negotiable instruments and other assets that are readily transferable in electronic form. The liquidity characteristics of these items make banks vulnerable to misappropriation and fraud. Banks therefore need to establish formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
 - They often engage in transactions that are initiated in one jurisdiction, recorded in a different jurisdiction and managed in yet another jurisdiction.
 - They operate with very high leverage (that is, the ratio of capital to total assets is low), which increases banks' vulnerability to adverse economic events and increases the risk of failure.
 - They have assets that can rapidly change in value and whose value is often difficult to determine. Consequentially a relatively small decrease in asset values may have a significant effect on their capital and potentially on their regulatory solvency.
 - They generally derive a significant amount of their funding from short-term deposits (either insured or uninsured). A loss of confidence by depositors in a bank's solvency may quickly result in a liquidity crisis.
 - They have fiduciary duties in respect of the assets they hold that belong to other persons. This may give rise to liabilities for breach of trust. They therefore need to establish operating procedures and internal controls designed to ensure that they deal with such assets only in accordance with the terms on which the assets were transferred to the bank.

- They engage in a large volume and variety of transactions whose value may be significant. This ordinarily requires complex accounting and internal control systems and widespread use of Information Technology (IT).
 - They ordinarily operate through networks of branches and departments that are geographically dispersed. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions, with consequential difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
 - Transactions can often be directly initiated and completed by the customer without any intervention by the bank's employees, for example over the Internet or through automatic teller machines (ATMs).
 - They often assume significant commitments without any initial transfer of funds other than, in some cases, the payment of fees. These commitments may involve only memorandum accounting entries. Consequently their existence may be difficult to detect.
 - They are regulated by governmental authorities, whose regulatory requirements often influence the accounting principles that banks follow. Non-compliance with regulatory requirements, for example, capital adequacy requirements, could have implications for the bank's financial statements or the disclosures therein.
 - Customer relationships that the auditor, assistants, or the audit firm may have with the bank might affect the auditor's independence in a way that customer relationships with other organizations would not.
 - They generally have exclusive access to clearing and settlement systems for checks, fund transfers, foreign exchange transactions, etc.
 - They are an integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.
 - They may issue and trade in complex financial instruments, some of which may need to be recorded at fair values in the financial statements. They therefore need to establish appropriate valuation and risk management procedures. The effectiveness of these procedures depends on the appropriateness of the methodologies and mathematical models selected, access to reliable current and historical market information, and the maintenance of data integrity.
7. Special audit considerations arise in the audits of banks because of matters such as the following:
- The particular nature of the risks associated with the transactions undertaken by banks.

- The scale of banking operations and the resultant significant exposures that may arise in a short period.
 - The extensive dependence on IT to process transactions.
 - The effect of the regulations in the various jurisdictions in which they operate.
 - The continuing development of new products and banking practices that may not be matched by the concurrent development of accounting principles or internal controls.
8. This Statement is organized into a discussion of the various aspects of the audit of a bank with emphasis being given to those matters that are either peculiar to, or of particular importance in, such an audit. Included for illustrative purposes are appendices that contain examples of:
- (a) Typical warning signs of fraud in banking operations;
 - (b) Typical internal controls, tests of control and substantive audit procedures for two of the major operational areas of a bank: treasury and trading operations and lending activities;
 - (c) Financial ratios commonly used in the analysis of a bank's financial condition and performance; and
 - (d) Risks and issues in securities operations, private banking and asset management.

Audit Objectives

9. ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" states:
- The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.
10. The objective of the audit of a bank's financial statements conducted in accordance with ISAs is, therefore, to enable the auditor to express an opinion on the bank's financial statements, which are prepared in accordance with an identified financial reporting framework.
11. The auditor's report indicates the financial reporting framework that has been used to prepare the bank's financial statements (including identifying the country of origin of the financial reporting framework when the framework used is not International Accounting Standards). When reporting on financial statements of a bank prepared specifically for use in a country other than that under whose rules it is established, the auditor considers whether the financial statements contain appropriate disclosures about the financial reporting

framework used. Paragraphs 101–103 of this Statement discuss the auditor’s report in more detail.

Agreeing the Terms of the Engagement

12. As stated in ISA 210, “Terms of Audit Engagements”:

The engagement letter documents and confirms the auditor’s acceptance of the appointment, the objective and scope of the audit, the extent of the auditor’s responsibilities to the client and the form of any reports.

13. Paragraph 6 lists some of the characteristics that are unique to banks and indicates the areas where the auditor and assistants may require specialist skills. In considering the objective and scope of the audit and the extent of the responsibilities, the auditor considers his own skills and competence and those of his assistants to conduct the engagement. In doing so, the auditor considers the following factors:

- The need for sufficient expertise in the aspects of banking relevant to the audit of the bank’s business activities;
- The need for expertise in the context of the IT systems and communication networks the bank uses; and
- The adequacy of resources or inter-firm arrangements to carry out the work necessary at the number of domestic and international locations of the bank at which audit procedures may be required.

14. In addition to the general factors set out in ISA 210, the auditor considers including comments on the following when issuing an engagement letter.

- The use and source of specialized accounting principles, with particular reference to:
 - Any requirements contained in the law or regulations applicable to banks;
 - Pronouncements of the banking supervisory and other regulatory authorities;
 - Pronouncements of relevant professional accounting bodies, for example, the International Accounting Standards Board;
 - Pronouncements of the Basel Committee on Banking Supervision; and
 - Industry practice.
- The contents and form of the auditor’s report on the financial statements and any special-purpose reports required from the auditor in addition to the report on the financial statements. This includes whether such reports refer to the application of regulatory or other special purpose accounting

principles or describe procedures undertaken especially to meet regulatory requirements.

- The nature of any special communication requirements or protocols that may exist between the auditor and the banking supervisory and other regulatory authorities.
- The access that bank supervisors will be granted to the auditor's working papers when such access is required by law, and the bank's advance consent to this access.

Planning the Audit

Introduction

15. The audit plan includes, among other things:

- Obtaining a sufficient knowledge of the entity's business and governance structure, and a sufficient understanding of the accounting and internal control systems, including risk management and internal audit functions;
- Considering the expected assessments of inherent and control risks, being the risk that material misstatements occur (inherent risk) and the risk that the bank's system of internal control does not prevent or detect and correct such misstatements on a timely basis (control risk);
- Determining the nature, timing and extent of the audit procedures to be performed; and
- Considering the going concern assumption regarding the entity's ability to continue in operation for the foreseeable future, which will be the period used by management in making its assessment under the financial reporting framework. This period will ordinarily be for a period of at least one year after the balance sheet date.

Obtaining a Knowledge of the Business

16. Obtaining a knowledge of the bank's business requires the auditor to understand:

- The bank's corporate governance structure;
- The economic and regulatory environment prevailing for the principal countries in which the bank operates; and
- The market conditions existing in each of the significant sectors in which the bank operates.

17. Corporate governance plays a particularly important role in banks; many regulators set out requirements for banks to have effective corporate governance structures. Accordingly the auditor obtains an understanding of the bank's corporate governance structure and how those charged with governance

discharge their responsibilities for the supervision, control and direction of the bank.

18. Similarly the auditor obtains and maintains a good working knowledge of the products and services offered by the bank. In obtaining and maintaining that knowledge, the auditor is aware of the many variations in the basic deposit, loan and treasury services that are offered and continue to be developed by banks in response to market conditions. The auditor obtains an understanding of the nature of services rendered through instruments such as letters of credit, acceptances, interest rate futures, forward and swap contracts, options and other similar instruments in order to understand the inherent risks and the auditing, accounting and disclosure implications thereof.
19. If the bank uses service organizations to provide core services or activities, such as cash and securities settlement, back office activities or internal audit services, the responsibility for compliance with rules and regulations and sound internal controls remains with those charged with governance and the management of the outsourcing bank. The auditor considers legal and regulatory restrictions, and obtains an understanding of how the management and those charged with governance monitor that the system of internal control (including internal audit) operates effectively. ISA 402, "Audit Considerations Relating to Entities Using Service Organizations" gives further guidance on this subject.
20. There are a number of risks associated with banking activities that, while not unique to banking, are important in that they serve to shape banking operations. The auditor obtains an understanding of the nature of these risks and how the bank manages them. This understanding allows the auditor to assess the levels of inherent and control risks associated with different aspects of a bank's operations and to determine the nature, timing and extent of the audit procedures.

Understanding the Nature of Banking Risks

21. The risks associated with banking activities may broadly be categorized as:

Country risk:	The risk of foreign customers and counterparties failing to settle their obligations because of economic, political and social factors of the counterparty's home country and external to the customer or counterparty;
Credit risk:	The risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. Credit risk, particularly from commercial lending, may be considered the most important risk in banking operations. Credit risk arises from lending to individuals, companies, banks and governments. It also exists in assets other than loans, such as investments, balances due from other banks and

	in off-balance sheet commitments. Credit risk also includes country risk, transfer risk, replacement risk and settlement risk.
Currency risk:	The risk of loss arising from future movements in the exchange rates applicable to foreign currency assets, liabilities, rights and obligations.
Fiduciary risk:	The risk of loss arising from factors such as failure to maintain safe custody or negligence in the management of assets on behalf of other parties.
Interest rate risk:	The risk that a movement in interest rates would have an adverse effect on the value of assets and liabilities or would affect interest cash flows.
Legal and documentary risk:	The risk that contracts are documented incorrectly or are not legally enforceable in the relevant jurisdiction in which the contracts are to be enforced or where the counterparties operate. This can include the risk that assets will turn out to be worth less or liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for the banking business and involve costs to it and many or all other banks; and laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering into new types of transactions and when the legal right of a counterparty to enter into a transaction is not established.
Liquidity risk:	The risk of loss arising from the changes in the bank's ability to sell or dispose of an asset.
Modeling risk:	The risk associated with the imperfections and subjectivity of valuation models used to determine the values of assets or liabilities.
Operational risk:	The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
Price risk:	The risk of loss arising from adverse changes in market prices, including interest rates, foreign exchange rates, equity and commodity prices and from movements in the market prices of investments.
Regulatory risk:	The risk of loss arising from failure to comply with

regulatory or legal requirements in the relevant jurisdiction in which the bank operates. It also includes any loss that could arise from changes in regulatory requirements.

- Replacement risk:** (Sometimes called performance risk) The risk of failure of a customer or counterparty to perform the terms of a contract. This failure creates the need to replace the failed transaction with another at the current market price. This may result in a loss to the bank equivalent to the difference between the contract price and the current market price.
- Reputational risk:** The risk of losing business because of negative public opinion and consequential damage to the bank's reputation arising from failure to properly manage some of the above risks, or from involvement in improper or illegal activities by the bank or its senior management, such as money laundering or attempts to cover up losses.
- Settlement risk:** The risk that one side of a transaction will be settled without value being received from the customer or counterparty. This will generally result in the loss to the bank of the full principal amount.
- Solvency risk:** The risk of loss arising from the possibility of the bank not having sufficient funds to meet its obligations, or from the bank's inability to access capital markets to raise required funds.
- Transfer risk:** The risk of loss arising when a counterparty's obligation is not denominated in the counterparty's home currency. The counterparty may be unable to obtain the currency of the obligation irrespective of the counterparty's particular financial condition.

22. Banking risks increase with the degree of concentration of a bank's exposure to any one customer, industry, geographic area or country. For example, a bank's loan portfolio may have large concentrations of loans or commitments to particular industries, and some, such as real estate, shipping and natural resources, may have highly specialized practices. Assessing the relevant risks relating to loans to entities in those industries may require a knowledge of these industries, including their business, operational and reporting practices.
23. Most transactions involve more than one of the risks identified above. Furthermore, the individual risks set out above may be correlated with one another. For example, a bank's credit exposure in a securities transaction may increase as a result of an increase in the market price of the securities concerned. Similarly, non-payment or settlement failure can have

consequences for a bank's liquidity position. The auditor therefore considers these and other risk correlations when analyzing the risks to which a bank is exposed.

24. Banks may be subject to risks arising from the nature of their ownership. For example, a bank's owner or a group of owners might try to influence the allocation of credit. In a closely held bank, the owners may have significant influence on the bank's management affecting their independence and judgment. The auditor considers such risks.
25. In addition to understanding the external factors that could indicate increased risk, the auditor considers the nature of risks arising from the bank's operations. Factors that contribute significantly to operational risk include the following.
 - The need to process high volumes of transactions accurately within a short time. This need is almost always met through the large-scale use of IT, with the resultant risks of:
 - Failure to carry out executed transactions within the required time, causing an inability to receive or make payments for those transactions;
 - Failure to carry out complex transactions properly;
 - Wide-scale misstatements arising from a breakdown in internal control;
 - Loss of data arising from systems' failure;
 - Corruption of data arising from unauthorized interference with the systems; and
 - Exposure to market risks arising from lack of reliable up-to-date information.
 - The need to use electronic funds transfer (EFT) or other telecommunications systems to transfer ownership of large sums of money, with the resultant risk of exposure to loss arising from payments to incorrect parties through fraud or error.
 - The conduct of operations in many locations with a resultant geographic dispersion of transaction processing and internal controls. As a result:
 - There is a risk that the bank's worldwide exposure by customer and by product may not be adequately aggregated and monitored; and
 - Control breakdowns may occur and remain undetected or uncorrected because of the physical separation between management and those who handle the transactions.
 - The need to monitor and manage significant exposures that can arise over short time-frames. The process of clearing transactions may cause a

significant build-up of receivables and payables during a day, most of which are settled by the end of the day. This is ordinarily referred to as intra-day payment risk. These exposures arise from transactions with customers and counterparties and may include interest rate, currency and market risks.

- The handling of large volumes of monetary items, including cash, negotiable instruments and transferable customer balances, with the resultant risk of loss arising from theft and fraud by employees or other parties.
 - The inherent complexity and volatility of the environment in which banks operate, resulting in the risk of inappropriate risk management strategies or accounting treatments in relation to such matters as the development of new products and services.
 - Operating restrictions may be imposed as a result of the failure to adhere to laws and regulations. Overseas operations are subject to the laws and regulations of the countries in which they are based as well as those of the country in which the parent entity has its headquarters. This may result in the need to adhere to differing requirements and a risk that operating procedures that comply with regulations in some jurisdictions do not meet the requirements of others.
26. Fraudulent activities may take place within a bank by, or with the knowing involvement of, management or personnel of the bank. Such frauds may include fraudulent financial reporting without the motive of personal gain, (for example, to conceal trading losses), or the misappropriation of the bank's assets for personal gain that may or may not involve the falsification of records. Alternatively, fraud may be perpetrated on a bank without the knowledge or complicity of the bank's employees. ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" gives more guidance on the nature of the auditor's responsibilities with respect to fraud. Although many areas of a bank's operations are susceptible to fraudulent activities, the most common take place in the lending, deposit-taking and dealing functions. The methods commonly used to perpetrate fraud and a selection of the fraud risk factors that indicate that a fraud may have occurred are set out in Appendix 1.
27. By the nature of their business, banks are ready targets for those engaged in money laundering activities by which the proceeds of crime are converted into funds that appear to have a legitimate source. In recent years drug traffickers in particular have greatly added to the scale of money laundering that takes place within the banking industry. In many jurisdictions, legislation requires banks to establish policies, procedures and controls to deter and to recognize and report money laundering activities. These policies, procedures and controls commonly extend to the following.
- A requirement to obtain customer identification ("know your client").

- Staff screening.
- A requirement to know the purpose for which an account is to be used.
- The maintenance of transaction records.
- The reporting to the authorities of suspicious transactions or of all transactions of a particular type, for example, cash transactions over a certain amount.
- The education of staff to assist them in identifying suspicious transactions.

In some jurisdictions, auditors may have an express obligation to report to the authorities certain types of transactions that come to their attention. Even where no such obligation exists, an auditor who discovers a possible instance of noncompliance with laws or regulations considers the implications for the financial statements and the audit opinion thereon. ISA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements” gives further guidance on this matter.

Understanding the risk management process

28. Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following.

- Oversight and involvement in the control process by those charged with governance

Those charged with governance should approve written risk management policies. The policies should be consistent with the bank’s business strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable. Those charged with governance are also responsible for establishing a culture within the bank that emphasizes their commitment to internal controls and high ethical standards, and often establish special committees to help discharge their functions. Management is responsible for implementing the strategies and policies set by those charged with governance and for ensuring that an adequate and effective system of internal control is established and maintained.

- Identification, measurement and monitoring of risks

Risks that could significantly impact the achievement of the bank’s goals should be identified, measured and monitored against pre-approved limits and criteria. This function may be conducted by an independent risk management unit, which is also responsible for validating and stress testing the pricing and valuation models used by the front and back offices. Banks ordinarily have a risk management unit that monitors risk management activities and evaluates the effectiveness of risk management

models, methodologies and assumptions used. In such situations, the auditor considers whether and how to use the work of that unit.

- Control activities

A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliations of positions and results, setting of limits, reporting and approval of exceptions to limits, physical security and contingency planning.

- Monitoring activities

Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by an independent risk management unit. Internal auditing should test the risk management process periodically to check whether management policies and procedures are complied with and whether the operational controls are effective. Both the risk management unit and internal auditing should have a reporting line to those charged with governance and management that is independent of those on whom they are reporting.

- Reliable information systems

Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

Development of an Overall Audit Plan

29. In developing an overall plan for the audit of the financial statements of a bank, the auditor gives particular attention to:

- The complexity of the transactions undertaken by the bank and the documentation in respect thereof;
- The extent to which any core activities are provided by service organizations;
- Contingent liabilities and off-balance sheet items;
- Regulatory considerations;
- The extent of IT and other systems used by the bank;
- The expected assessments of inherent and control risks;
- The work of internal auditing;
- The assessment of audit risk;

- The assessment of materiality;
- Management's representations;
- The involvement of other auditors;
- The geographic spread of the bank's operations and the co-ordination of work between different audit teams;
- The existence of related party transactions; and
- Going concern considerations.

These matters are discussed in subsequent paragraphs.

The Complexity of Transactions Undertaken

30. Banks typically have a wide diversity of activities, which means that it is sometimes difficult for an auditor to fully understand the implications of particular transactions. The transactions may be so complex that management itself fails to analyze properly the risks of new products and services. The wide geographic spread of a bank's activities can also lead to difficulties. Banks undertake transactions that have complex and important underlying features that may not be apparent from the documentation that is used to process the transactions and to enter them into the bank's accounting records. This results in the risk that all aspects of a transaction may not be fully or correctly recorded or accounted for, with the resultant risks of:

- Loss due to the failure to take timely corrective action;
- Failure to make adequate provisions for loss on a timely basis; and
- Inadequate or improper disclosure in the financial statements and other reports.

The auditor obtains an understanding of the bank's activities and the transactions it undertakes sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.

31. Many of the amounts to be recorded or disclosures made in the financial statements involve the exercise of judgment by management, for example, loan loss provisions, and provisions against financial instruments such as liquidity risk provision, modeling risk provision and reserve for operational risk. The greater the judgment required, the greater the inherent risk and the greater the professional judgment required by the auditor. Similarly, there may be other significant items in the financial statements that involve accounting estimates. The auditor considers the guidance set out in ISA 540, "Audit of Accounting Estimates."

The Extent to Which any Core Activities are Provided by Service Organizations

32. In principle, the considerations when a bank uses service organizations are no different from the considerations when any other entity uses them. However, banks sometimes use service organizations to perform parts of their core activities, such as credit and cash management. When the bank uses service organizations for such activities, the auditor may find it difficult to obtain sufficient appropriate audit evidence without the cooperation of the service organization. ISA 402 provides further guidance on the auditing considerations and the types of reports that auditors of service organizations provide to the organization's clients.

Contingent Liabilities and Off-Balance Sheet Items

33. Banks also typically engage in transactions that:
- Have a low fee revenue or profit element as a percentage of the underlying asset or liability;
 - Local regulations may not require to be disclosed in the balance sheet, or even in the notes to the financial statements;
 - Are recorded only in memorandum accounts; or
 - Involve securitizing and selling assets so that they no longer appear in the bank's financial statements.

Examples of such transactions are safe custody services, guarantees, comfort letters and letters of credit, interest rate and currency swaps and commitments and options to purchase and sell foreign exchange.

34. The auditor reviews the bank's sources of revenue, and obtains sufficient appropriate audit evidence regarding the following:
- (a) The accuracy and completeness of the accounting records relating to such transactions;
 - (b) The existence of proper controls to limit the banking risks arising from such transactions;
 - (c) The adequacy of any provisions for loss which may be required; and
 - (d) The adequacy of any financial statement disclosures which may be required.

Regulatory Considerations

35. The International Auditing Practices Statement 1004 provides information and guidance on the relationship between bank auditors and banking supervisors. The Basel Committee has issued supervisory guidance regarding sound banking practices for managing risks, internal control systems, loan accounting and disclosure, other disclosures and for other areas of bank activities. In addition, the Basel Committee has issued guidance on the assessment of capital adequacy and other important supervision topics. This

guidance is available to the auditor and to the public on the internet web site of the Bank for International Settlements (BIS).

36. In accordance with ISA 310, the auditor considers whether the assertions in the financial statements are consistent with the auditor's knowledge of the business. In many regulatory frameworks, the level and types of business a bank is allowed to undertake depend upon the level of its assets and liabilities and the types and perceived risks attached to those assets and liabilities (a risk-weighted capital framework). In such circumstances there are greater pressures for management to engage in fraudulent financial reporting by miscategorizing assets and liabilities or by describing them as being less risky than they actually are, particularly when the bank is operating at, or close to, the minimum required capital levels.
37. There are many procedures that both auditors and bank supervisors perform, including:
 - The performance of analytical procedures;
 - Obtaining evidence regarding the operation of the internal control system; and
 - The review of the quality of a bank's assets and the assessment of banking risks.

The auditor therefore finds it advantageous to interact with the supervisors and to have access to communications that the supervisors may have addressed to the bank management on the results of their work. The assessment made by the supervisors in important areas such as the adequacy of risk management practices and provisions for loan losses, and the prudential ratios used by the supervisors can be of assistance to the auditor in performing analytical procedures and in focusing attention on specific areas of supervisory concern.

The Extent of IT and Other Systems

38. The high volume of transactions and the short times in which they must be processed typically result in most banks making extensive use of IT, EFT and other telecommunications systems.

The control concerns arising from the use of IT by a bank are similar to those arising when IT is used by other organizations. However, the matters that are of particular concern to the auditor of a bank include the following.

- The use of IT to calculate and record substantially all of the interest income and interest expense, which are ordinarily two of the most important elements in the determination of a bank's earnings.
- The use of IT and telecommunications systems to determine the foreign exchange security and derivative trading positions, and to calculate and record the gains and losses arising from them.

- The extensive, and in some cases almost total, dependence on the records produced by IT because they represent the only readily accessible source of detailed up-to-date information on the bank's assets and liability positions, such as customer loan and deposit balances.
- The use of complex valuation models incorporated in the IT systems.
- The models used to value assets and the data used by those models are often kept in spreadsheets prepared by individuals on personal computers not linked to the bank's main IT systems and not subject to the same controls as applications on those systems. IAPS 1001, "IT Environments—Stand-Alone Personal Computers" provides guidance to auditors in respect of these applications.
- The use of different IT systems resulting in the risk of loss of audit trail and incompatibility of different systems.

EFT systems are used by banks both internally (for example, for transfers between branches and between automated banking machines and the computerized files that record account activity) and externally between the bank and other financial institutions (for example, through the SWIFT network) and also between the bank and its customers through the internet or other electronic commerce media.

39. The auditor obtains an understanding of the core IT, EFT and telecommunication applications and the links between those applications. The auditor relates this understanding to the major business processes or balance sheet positions in order to identify the risk factors for the organization and therefore for the audit. In addition, it is important to identify the extent of the use of self-developed applications or integrated systems, which will have a direct effect on the audit approach. (Self-developed systems require the auditor to focus more extensively on the program change controls.)
40. When auditing in a distributed IT environment, the auditor obtains an understanding of where the core IT applications are located. If the bank's wide area network (WAN) is dispersed over several countries, specific legislative rules might apply to cross-border data processing. In such an environment, audit work on the access control system, especially on the access violation system, is an important part of the audit.
41. An electronic commerce environment changes significantly the way the bank conducts its business. Electronic commerce presents new aspects of risk and other considerations that the auditor addresses. For example, the auditor considers the following.
 - The business risks the bank's e-commerce strategy presents.
 - The risks inherent in the technology the bank has chosen to implement its e-commerce strategy.

- Management's responses to the risks identified, including control considerations regarding:
 - Compliance with legal and regulatory requirements in respect of cross-border transactions;
 - The security and privacy of transmissions across the Internet; and
 - The completion, accuracy, timeliness and authorization of Internet transactions as they are recorded in the bank's accounting system.
 - The level of IT and e-commerce skill and competence the auditor and assistants possess.
42. An organization may outsource IT or EFT related activities to an external service provider. The auditor gains an understanding of the outsourced services and the system of internal controls within the outsourcing bank and the vendor of the services, in order to determine the nature, extent and timing of substantive procedures. ISA 402 gives further guidance on this subject.

Expected Assessment of Inherent and Control Risks

43. The nature of banking operations is such that the auditor may not be able to reduce audit risk to an acceptably low level by the performance of substantive procedures alone. This is because of factors such as the following.
- The extensive use of IT and EFT systems, which means that much of the audit evidence is available only in electronic form and is produced by the entity's own IT systems.
 - The high volume of transactions entered into by banks, which makes reliance on substantive procedures alone impracticable.
 - The geographic dispersion of banks' operations, which makes obtaining sufficient coverage extremely difficult.
 - The difficulty in devising effective substantive procedures to audit complex trading transactions.

In most situations the auditor will not be able to reduce audit risk to an acceptably low level unless management has instituted an internal control system that allows the auditor to be able to assess the level of inherent and control risks as less than high. The auditor obtains sufficient appropriate audit evidence to support the assessment of inherent and control risks. Paragraphs 56–70 discuss matters relating to internal control in more detail.

The Work of Internal Auditing

44. The scope and objectives of internal auditing may vary widely depending upon the size and structure of the bank and the requirements of management and those charged with governance. However, the role of internal auditing ordinarily includes the review of the accounting system and related internal

controls, monitoring their operation and recommending improvements to them. It also generally includes a review of the means used to identify, measure and report financial and operating information and specific inquiry into individual items including detailed testing of transactions, balances and procedures. The factors referred to in paragraph 44 also often lead the auditor to use the work of internal auditing. This is especially relevant in the case of banks that have a large geographic dispersion of branches. Often, as a part of the internal audit department or as a separate component, a bank has a loan review department that reports to management on the quality of loans and the adherence to established procedures in respect thereof. In either case, the auditor often considers making use of the work of the loan review department after an appropriate review of the department and its work. Guidance on the use of the work of internal auditing is provided in ISA 610, “Considering the Work of Internal Auditing.”

Audit Risk

45. The three components of audit risk are:
- (a) Inherent risk (the risk that material misstatements occur);
 - (b) Control risk (the risk that the bank’s system of internal control does not prevent or detect and correct such misstatements on a timely basis); and
 - (c) Detection risk (the risk that the auditor will not detect any remaining material misstatements).

Inherent and control risks exist independently of the audit of financial information and the auditor cannot influence them. The nature of risks associated with banking activities, which are discussed in paragraphs 21 to 25 indicate that the assessed level of inherent risk in many areas will be high. It is therefore necessary for a bank to have an adequate system of internal control if the levels of inherent and control risks are to be less than high. The auditor assesses these risks and designs substantive procedures so as to reduce audit risk to an acceptably low level.

Materiality

46. In making an assessment of materiality, in addition to the considerations set out in ISA 320, “Audit Materiality,” the auditor considers the following factors.
- Because of high leverage, relatively small misstatements may have a significant effect on the results for the period and on capital, even though they may have an insignificant effect on total assets.
 - A bank’s earnings are low when compared to its total assets and liabilities and its off-balance sheet commitments. Therefore, misstatements that relate only to assets, liabilities and commitments may be less significant than those that may also relate to the statement of earnings.

- Banks are often subject to regulatory requirements, such as the requirement to maintain minimum levels of capital. A breach of these requirements could call into question the appropriateness of management's use of the going concern assumption. The auditor therefore establishes a materiality level so as to identify misstatements that, if uncorrected, would result in a significant contravention of such regulatory requirements.
- The appropriateness of the going concern assumption often depends upon matters related to the bank's reputation as a sound financial institution and actions by regulators. Because of this, related party transactions and other matters that would not be material to entities other than banks may become material to a bank's financial statements if they might affect the bank's reputation or actions by regulators.

Management's Representations

47. Management's representations are relevant in the context of a bank audit to assist the auditor in determining whether the information and evidence obtained is complete for the purposes of the audit. This is particularly true of the bank's transactions that may not ordinarily be reflected in the financial statements (off-balance sheet items), but which may be evidenced by other records of which the auditor may not be aware. It is often also necessary for the auditor to obtain from management representations regarding significant changes in the bank's business and its risk profile. It may also be necessary for the auditor to identify areas of a bank's operations where audit evidence likely to be obtained may need to be supplemented by management's representations, for example, loan loss provisions and the completeness of correspondence with regulators. ISA 580, "Management Representations" provides guidance as to the use of management representations as audit evidence, the procedures that the auditor applies in evaluating and documenting them, and the circumstances in which representations should be obtained in writing.

Involvement of Other Auditors

48. As a result of the wide geographic dispersion of offices in most banks, it is often necessary for the auditor to use the work of other auditors in many of the locations in which the bank operates. This may be achieved by using other offices of the auditor's firm or by using other auditing firms in those locations.
49. Before using the work of another auditor, the auditor:
 - Considers the independence of those auditors and their competence to undertake the necessary work (including their knowledge of banking and applicable regulatory requirements);
 - Considers whether the terms of the engagement, the accounting principles to be applied and the reporting arrangements are clearly communicated; and

- Performs procedures to obtain sufficient appropriate audit evidence that the work performed by the other auditor is adequate for this purpose by discussion with the other auditor, by a review of a written summary of the procedures applied and findings, by a review of the working papers of the other auditor, or in any other manner appropriate to the circumstances.

ISA 600, “Using the Work of Another Auditor” provides further guidance on the issues to be addressed and procedures to be performed in such situations.

Co-ordinating the Work to be Performed

50. Given the size and geographic dispersion of most banks, co-ordinating the work to be performed is important to achieve an efficient and effective audit. The co-ordination required takes into account factors such as the following.
 - The work to be performed by:
 - Experts;
 - Assistants;
 - Other offices of the auditor’s firm; and
 - Other audit firms.
 - The extent to which it is planned to use the work of internal auditing.
 - Required reporting dates to shareholders and the regulatory authorities.
 - Any special analyses and other documentation to be provided by bank management.
51. The best level of co-ordination between assistants can often be achieved by regular audit-status meetings. However, given the number of assistants and the number of locations at which they will be involved, the auditor ordinarily communicates all or relevant portions of the audit plan in writing. When setting out the requirements in writing, the auditor considers including commentary on the following matters.
 - The financial statements and other information that are to be audited (and if considered necessary, the legal or other mandate for the audit).
 - Details of any additional information requested by the auditor, for example, information on certain loans, portfolio composition, narrative commentary on the audit work to be performed (especially on the areas of risk described in paragraphs 21 to 25 which are important to the bank) and on the results of the audit work, potential points for inclusion in letters to management on internal control, local regulatory concerns, and if relevant, the forms of any required reports.
 - That the audit is to be conducted in accordance with ISAs and any local regulatory requirements (and, if considered necessary, information on those requirements).

- The relevant accounting principles to be followed in the preparation of the financial statements and other information (and, if considered necessary, the details of those principles).
- Interim audit status reporting requirements and deadlines.
- Particulars of the entity's officials to be contacted.
- Fee and billing arrangements.
- Any other concerns of a regulatory, internal control, accounting or audit nature of which those conducting the audit should be aware.

Related Party Transactions

52. The auditor remains alert for related party transactions during the course of the audit, particularly in the lending and investment areas. Procedures performed during the planning phase of the audit, including obtaining an understanding of the bank and the banking industry, may be helpful in identifying related parties. In some jurisdictions, related party transactions may be subject to quantitative or qualitative restrictions. The auditor determines the extent of any such restrictions.

Going Concern Considerations

53. ISA 570, "Going Concern" provides guidance as to the auditor's consideration of the appropriateness of management's use of the going concern assumption. In addition to matters identified in that ISA, events or conditions such as the following may also cast significant doubt on the bank's ability to continue as a going concern.
 - Rapid increases in levels of trading in derivatives. This may indicate that the bank is carrying out trading activities without the necessary controls in place.
 - Profitability performance or forecasts that suggest a serious decline in profitability, particularly if the bank is at or near its minimum regulatory capital or liquidity levels.
 - Rates of interest being paid on money market and depositor liabilities that are higher than normal market rates. This may indicate that the bank is viewed as a higher risk.
 - Significant decreases in deposits from other banks or other forms of short term money market funding. This may indicate that other market participants lack confidence in the bank.
 - Actions taken or threatened by regulators that may have an adverse effect on the bank's ability to continue as a going concern.
 - Increased amounts due to central banks, which may indicate that the bank was unable to obtain liquidity from normal market sources.

- High concentrations of exposures to borrowers or to sources of funding.
54. ISA 570 also provides guidance to auditors when an event or condition that may cast significant doubt on the bank's ability to continue as a going concern has been identified. The ISA indicates a number of procedures that may be relevant, and in addition to those, the following procedures may also be relevant.
- Reviewing correspondence with regulators.
 - Reviewing reports issued by regulators as a result of regulatory inspections.
 - Discussing the results of any inspections currently in process.
55. The regulatory regime under which the bank operates may require the auditor to disclose to the regulator any intention to issue a modified opinion or any concerns that the auditor may have about the bank's ability to continue as a going concern. IAPS 1004 provides further discussion of the relationship between the auditor and the banking supervisor.

Internal Control

Introduction

56. The Basel Committee on Banking Supervision has issued a policy paper, "Framework for Internal Control Systems in Banking Organisations" (September 1998), which provides banking supervisors with a framework for evaluating banks' internal control systems. This framework is used by many banking supervisors, and may be used during supervisory discussions with individual banking organizations. Auditors of banks' financial statements may find a knowledge of this framework useful in understanding the various elements of a bank's internal control system.
57. Management's responsibilities include the maintenance of an adequate accounting system and internal control system, the selection and application of accounting policies, and the safeguarding of the assets of the entity.

The auditor obtains an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. After obtaining the understanding, the auditor considers the assessment of inherent and control risks so as to determine the appropriate detection risk to accept for the financial statement assertions and to determine the nature, timing and extent of substantive procedures for such assertions.

Where the auditor assesses control risk at less than high, substantive procedures are ordinarily less extensive than are otherwise required and may also differ in their nature and timing.

Identifying, Documenting and Testing Control Procedures

58. ISA 400, “Risk Assessments and Internal Control” indicates that internal controls relating to the accounting system are concerned with achieving objectives such as the following.
- Transactions are executed in accordance with management’s general or specific authorization (paragraphs 59–61).
 - All transactions and other events are promptly recorded at the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with an identified financial reporting framework (paragraphs 62 and 63).
 - Access to assets is permitted only in accordance with management’s authorization (paragraphs 64 and 65).
 - Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken regarding any differences (paragraphs 66 and 67).

The audit considerations in relation to each of these objectives are discussed in the subsequent paragraphs.

In the case of banks, a further objective of internal controls is to ensure that the bank adequately fulfills its regulatory and fiduciary responsibilities arising out of its trustee activities. The auditor is not directly concerned with these objectives except to the extent that any failure to comply with such responsibilities might have led to the financial statements being material misstated.

Transactions are executed in accordance with management’s general or specific authorization

59. The overall responsibility for the system of internal control in a bank rests with those charged with governance, who are responsible for governing the bank’s operations. However, since banks’ operations are generally large and dispersed, decision-making functions need to be decentralized and the authority to commit the bank to material transactions is ordinarily dispersed and delegated among the various levels of management and staff. Such dispersion and delegation will almost always be found in the lending, treasury and funds transfer functions, where, for example, payment instructions are sent via a secure message. This feature of banking operations creates the need for a structured system of delegation of authority, resulting in the formal identification and documentation of:
- (a) Those who may authorize specific transactions;
 - (b) Procedures to be followed in granting that authorization; and

- (c) Limits on the amounts that can be authorized, by individual employee or by staff level, as well as any requirements that may exist for concurring authorization.

Those charged with governance also need to ensure that appropriate procedures exist for monitoring the level of exposures. This will ordinarily involve the aggregation of exposures, not only within, but also across, the different activities, departments and branches of the bank.

60. An examination of the authorization controls will be important to the auditor in considering whether transactions have been entered into in accordance with the bank's policies and, for example, in the case of the lending function, that they have been subject to appropriate credit assessment procedures prior to the disbursement of funds. The auditor will typically find that limits for levels of exposures exist in respect of various transaction types. When performing tests of controls, the auditor considers whether these limits are being adhered to and whether positions in excess of these limits are reported to the appropriate level of management on a timely basis.
61. From an audit perspective, the proper functioning of a bank's authorization controls is particularly important in respect of transactions entered into at or near the date of the financial statements. This is because aspects of the transaction have yet to be fulfilled, or there may be a lack of evidence with which to assess the value of the asset acquired or liability incurred. Examples of such transactions are commitments to purchase or sell specific securities after the period-end and loans, where principal and interest payments from the borrower have yet to be made.

All transactions and other events are promptly recorded at the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with an identified financial reporting framework.

62. In considering the internal controls that management use to ensure that all transactions and other events are properly recorded, the auditor takes into account a number of factors that are especially important in a banking environment. These include the following.
- Banks deal in large volumes of transactions that can individually or cumulatively involve large sums of money. Accordingly, the bank needs to have balancing and reconciliation procedures that are carried out within a time-frame that allows the detection of errors and discrepancies so that they can be investigated and corrected with minimal loss to the bank. Such procedures may be carried out hourly, daily, weekly, or monthly, depending on the volume and nature of the transaction, level of risk, and transactions settlement time-frame. The purpose of these reconciliations is often to ensure the completeness of transaction processing across highly complex integrated IT systems and the reconciliations themselves are normally automatically generated by these systems.

- Many of the transactions entered into by banks are subject to specialized accounting rules. Banks should have control procedures in place to ensure those rules are applied in the preparation of appropriate financial information for management and external reporting. Examples of such control procedures are those that result in the market revaluation of foreign exchange and security purchase and sale commitments so as to ensure that all unrealized profits and losses are recorded.
 - Some of the transactions entered into by banks may not be required to be disclosed in the financial statements (for example, transactions that the accounting framework allows to be regarded as off balance sheet items). Accordingly, control procedures must be in place to ensure that such transactions are recorded and monitored in a manner that provides management with the required degree of control over them and that allows for the prompt determination of any change in their status that needs to result in the recording of a profit or loss.
 - Banks are constantly developing new financial products and services. The auditor considers whether the necessary revisions are made in accounting procedures and related internal controls.
 - End of day balances may reflect the volume of transactions processed through the systems or of the maximum exposure to loss during the course of a business day. This is particularly relevant in executing and processing foreign exchange and securities transactions. The assessment of controls in these areas takes into account the ability to maintain control during the period of maximum volumes or maximum financial exposure.
 - The majority of banking transactions must be recorded in a manner that is capable of being verified both internally and by the bank's customers and counterparties. The level of detail to be recorded and maintained on individual transactions must allow the bank's management, transaction counterparties, and customers to verify the accuracy of the amounts and terms. An example of such a control is the continuous verification of foreign exchange trade tickets by having an employee not involved in the transaction match the tickets to incoming confirmations from counterparties.
63. The extensive use of IT and EFT systems has a significant effect on how the auditor evaluates a bank's accounting system and related internal controls. ISA 400, "Risk Assessments and Internal Control," ISA 401, "Auditing in a Computer Information Systems Environment," and IAPS 1008, "Risk Assessments and Internal Control—CIS Characteristics and Considerations," provide guidance on the IT aspects of such an evaluation, as do other IAPSs dealing with information technology. The audit procedures include an assessment of those controls that affect system development and modifications, system access and data entry, the security of communications networks, and contingency planning. Similar considerations apply to EFT operations within the bank. To the extent that EFT and other transaction

systems are external to the bank, the auditor gives additional emphasis to the assessment of the integrity of pre-transaction supervisory controls and post-transaction confirmation and reconciliation procedures. Reports from the auditors of service organizations may be of use here, and ISA 402 gives guidance on the auditor's consideration of such reports.

Access to assets is permitted only in accordance with management's authorization.

64. A bank's assets are often readily transferable, of high value and in a form that cannot be safeguarded solely by physical procedures. In order to ensure that access to assets is permitted only in accordance with management's authorization, a bank generally uses controls such as the following.
- Passwords and joint access arrangements to limit IT and EFT system access to authorized employees.
 - Segregation of the record-keeping and custody functions (including the use of computer generated transaction confirmation reports available immediately and only to the employee in charge of the record-keeping functions).
 - Frequent third-party confirmation and reconciliation of asset positions by an independent employee.
65. The auditor considers whether each of these controls is operating effectively. However, given the materiality and transferability of the amounts involved, the auditor also ordinarily reviews the confirmation and reconciliation procedures that occur in connection with the preparation of the year-end financial statements and may carry out confirmation procedures himself.

Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken regarding any differences

66. The large amounts of assets handled by banks, the volumes of transactions undertaken, the potential for changes in the value of those assets due to fluctuations in market prices and the importance of confirming the continued operation of access and authorization controls necessitates the frequent operation of reconciliation controls. This is particularly important for:
- (a) Assets in negotiable form, such as cash, bearer securities and assets in the form of deposit and security positions with other institutions where failure to detect errors and discrepancies quickly (which may mean daily where money market transactions are involved) could lead to an irrecoverable loss: reconciliation procedures used to achieve this control objective will ordinarily be based on physical counting and third party confirmation;
 - (b) Assets whose value is determined with reference to valuation models or external market prices, such as securities and foreign exchange contracts; and

(c) Assets held on behalf of clients.

67. In designing an audit plan to assess the effectiveness of a bank's reconciliation controls, the auditor considers factors such as the following.
- Because of the number of accounts requiring reconciliation and the frequency with which these reconciliations need to be performed:
 - Much of the audit effort is directed to the documentation, testing and evaluation of the reconciliation controls; and
 - The work of the internal auditor will also be similarly directed. The auditor therefore can ordinarily use the work of internal auditing.
 - Since reconciliations are cumulative in their effect, most reconciliations can be satisfactorily audited at the year-end date, assuming that they are prepared as of that date, soon enough for the auditor to use and that the auditor is satisfied that the reconciliation control procedures are effective.
 - In examining a reconciliation, the auditor considers whether items have not been improperly transferred to other accounts that are not subject to reconciliation and investigation at the same time.

Examples Of Controls

68. Appendix 2 to this Statement contains examples of controls over authorization, recording, access and reconciliation ordinarily found in the treasury and trading and lending operations of a bank.

Inherent Limitations Of Internal Control

69. ISA 400 "Risk Assessments and Internal Control" describes the procedures to be followed by the auditor in identifying, documenting and testing internal controls. In doing so, the auditor is aware of the inherent limitations of internal control. The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. Irrespective of the assessed levels of inherent and control risks, the auditor performs some substantive procedures for material account balances and classes of transactions.

Considering The Influence Of Environmental Factors

70. In assessing the effectiveness of specific control procedures, the auditor considers the environment in which internal control operates. Some of the factors that may be considered include the following.
- The organizational structure of the bank and the manner in which it provides for the delegation of authority and responsibilities.
 - The quality of management supervision.
 - The extent and effectiveness of internal auditing.

- The extent and effectiveness of the risk management and compliance systems
- The skills, competence and integrity of key personnel.
- The nature and extent of inspection by supervisory authorities.

Performing Substantive Procedures

Introduction

71. As a result of the assessment of the level of inherent and control risks, the auditor determines the nature, timing and extent of the substantive tests to be performed on individual account balances and classes of transactions. In designing these substantive tests, the auditor considers the risks and factors that served to shape the bank's systems of internal control. In addition, there are a number of audit considerations significant to these risk areas to which the auditor directs attention. These are discussed in subsequent paragraphs.
72. ISA 500, "Audit Evidence" lists the assertions embodied in the financial statements as: existence, rights and obligations, occurrence, completeness, valuation, measurement, and presentation and disclosure.

Tests of the completeness assertion are particularly important in the audit of bank's financial statements particularly in respect of liabilities. Much of the audit work on liabilities of other commercial entities can be carried out by substantive procedures on a reciprocal population. Banking transactions do not have the same type of regular trading cycle, and reciprocal populations are not always immediately in evidence. Large assets and liabilities can be created and realized very quickly and, if not captured by the systems, may be overlooked. Third party confirmations and the reliability of controls become important in these circumstances.

Audit Procedures

73. To address the assertions discussed above, the auditor may perform the following procedures:
 - (a) Inspection;
 - (b) Observation;
 - (c) Inquiry and confirmation;
 - (d) Computation; and
 - (e) Analytical procedures.

In the context of the audit of a bank's financial statements, inspection, inquiry and confirmation, computation and analytical procedures require particular attention and are discussed in the following paragraphs.

Inspection

74. Inspection consists of examining records, documents, or tangible assets. The auditor inspects in order to:
- Be satisfied as to the physical existence of material negotiable assets that the bank holds; and
 - Obtain the necessary understanding of the terms and conditions of agreements (including master agreements) that are significant individually or in the aggregate in order to:
 - Consider their enforceability; and
 - Assess the appropriateness of the accounting treatment they have been given.
75. Examples of areas where inspection is used as an audit procedure are:
- Securities;
 - Loan agreements;
 - Collateral; and
 - Commitment agreements, such as:
 - Asset sales and repurchases
 - Guarantees.
76. In carrying out inspection procedures, the auditor remains alert to the possibility that some of the assets the bank holds may be held on behalf of third parties rather than for the bank's own benefit. The auditor considers whether adequate internal controls exist for the proper segregation of such assets from those that are the property of the bank and, where such assets are held, considers the implications for the financial statements. As noted in paragraph 58 the auditor is concerned with the existence of third party assets only to the extent that the bank's failure to comply with its obligations may lead to the financial statements being materially misstated.

Inquiry and Confirmation

77. Inquiry consists of seeking information of knowledgeable persons inside or outside the entity. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. The auditor inquires and confirms in order to:
- Obtain evidence of the operation of internal controls;
 - Obtain evidence of the recognition by the bank's customers and counterparties of amounts, terms and conditions of certain transactions; and

- Obtain information not directly available from the bank's accounting records.

A bank has significant amounts of monetary assets and liabilities, and of off-balance-sheet commitments. External confirmation may be an effective method of determining the existence and completeness of the amounts of assets and liabilities disclosed in the financial statements. In deciding the nature and extent of external confirmation procedures that the auditor will perform, the auditor considers any external confirmation procedures undertaken by internal auditing. ISA 505, "External Confirmations" provides guidance on the external confirmation process.

78. Examples of areas for which the auditor may use confirmation are:

- Collateral.
- Verifying or obtaining independent confirmation of, the value of assets and liabilities that are not traded or are traded only on over-the-counter markets.
- Asset, liability and forward purchase and sale positions with customers and counterparties such as:
 - Outstanding derivative transactions;
 - *Nostro* and *vostro* account holders;
 - Securities held by third parties;
 - Loan accounts;
 - Deposit accounts;
 - Guarantees; and
 - Letters of credit.
- Legal opinions on the validity of a bank's claims.

Computation

79. Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations. In the context of the audit of a bank's financial statements, computation is a useful procedure for checking the consistent application of valuation models.

Analytical Procedures

80. Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predicted amounts. ISA 520, "Analytical Procedures" provides guidance on the auditor's use of this technique.

81. A bank invariably has individual assets (for example, loans and, possibly, investments) that are of such a size that the auditor considers them individually. However, for most items, analytical procedures may be effective for the following reasons.

- Ordinarily two of the most important elements in the determination of a bank's earnings are interest income and interest expense. These have direct relationships to interest bearing assets and interest bearing liabilities, respectively. To establish the reasonableness of these relationships, the auditor can examine the degree to which the reported income and expense vary from the amounts calculated on the basis of average balances outstanding and the bank's stated rates during the year. This examination is ordinarily made in respect of the categories of assets and liabilities used by the bank in the management of its business. Such an examination could, for example, highlight the existence of significant amounts of non-performing loans or unrecorded deposits. In addition, the auditor may also consider the reasonableness of the bank's stated rates to those prevailing in the market during the year for similar classes of loans and deposits. In the case of loan assets, evidence of rates charged or allowed above market rates may indicate the existence of excessive risk. In the case of deposit liabilities, such evidence may indicate liquidity or funding difficulties. Similarly, fee income, which is also a large component of a bank's earnings, often bears a direct relationship to the volume of obligations on which the fees have been earned.
- The accurate processing of the high volume of transactions entered into by a bank, and the auditor's assessment of the bank's internal controls, may benefit from the review of ratios and trends and of the extent to which they vary from previous periods, budgets and the results of other similar entities.
- By using analytical procedures, the auditor may detect circumstances that call into question the appropriateness of the going concern assumption, such as undue concentration of risk in particular industries or geographic areas and potential exposure to interest rate, currency and maturity mismatches.
- In most countries there is a wide range of statistical and financial information available from regulatory and other sources that the auditor can use to conduct an in-depth analytical review of trends and peer group analyses.

A useful starting point in considering appropriate analytical procedures is to consider what information and performance or risk indicators management use in monitoring the bank's activities. Appendix 3 to this Statement contains examples of the most frequently used ratios in the banking industry.

Specific Procedures in Respect of Particular Items in the Financial Statements

82. Paragraphs 83–100 identify the assertions that are ordinarily of particular importance in relation to the typical items in a bank’s financial statements. They also describe some of the audit considerations that help the auditor to plan substantive procedures and suggest some of the techniques that could be used in relation to the items selected by the auditor for testing. The procedures do not represent an exhaustive list of procedures that it is possible to perform, nor do they represent a minimum requirement that should always be performed.

Financial Statement Item	Financial Statement Assertions of Particular Importance
83.	<p data-bbox="482 624 894 649">BALANCES WITH OTHER BANKS</p> <p data-bbox="482 666 587 691">Existence</p> <p data-bbox="482 709 1081 1054">The auditor considers third party confirmations of the balance. Where the balances held with other banks are the result of large volumes of transactions, the receipt of confirmations from those other banks is likely to provide more cogent evidence as to the existence of the transactions and of the resultant inter-bank balances than is the testing of the related internal controls. Guidance on inter-bank confirmation procedures, including terminology and the content of confirmation requests, can be found in the IAPS 1000, “Inter-Bank Confirmation Procedures.”</p> <p data-bbox="482 1072 587 1097">Valuation</p> <p data-bbox="482 1114 1081 1266">The auditor considers whether to assess the collectability of the deposit in light of the credit-worthiness of the depository bank. The procedures required in such an assessment are similar to those used in the audit of loan valuation, discussed later.</p> <p data-bbox="482 1284 780 1308">Presentation and Disclosure</p> <p data-bbox="482 1326 1081 1584">The auditor considers whether the balances with other banks as at the date of the financial statements represent bona fide commercial transactions or whether any significant variation from normal or expected levels reflects transactions entered into primarily to give a misleading impression of the financial position of the bank or to improve liquidity and asset ratios (often known as “window-dressing”).</p> <p data-bbox="482 1587 1081 1638">Where window-dressing occurs in a magnitude which may distort the true and fair view of the financial</p>

statements, the auditor requests management to adjust the balances shown in the financial statements, or make additional disclosure in the notes. If management fails to do so, the auditor considers whether to modify the audit report.

84.

MONEY MARKET INSTRUMENTS

Existence

The auditor considers the need for physical inspection or confirmation with external custodians and the reconciliation of the related amounts with the accounting records.

Rights and Obligations

The auditor considers the feasibility of checking for receipt of the related income as a means of establishing ownership. The auditor pays particular attention to establishing the ownership of instruments held in bearer form. The auditor also considers whether there are any encumbrances on the title to the instruments.

The auditor tests for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.

Valuation

The auditor considers the appropriateness of the valuation techniques employed in light of the creditworthiness of the issuer.

Measurement

The auditor considers whether there is a need to test for the proper accrual of income earned on money market instruments, which in some cases is through the amortization of a purchase discount.

The auditor also considers whether:

- The relationship between the types of securities owned and the related income is reasonable; and
- All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).

85.

SECURITIES HELD FOR TRADING PURPOSES

Appendix 2 gives further examples of internal control

considerations and audit procedures in respect of trading operations.

Existence

The auditor considers physical inspection of securities or confirmation with external custodians and the reconciliation of the amounts with the accounting records.

Rights and Obligations

The auditor considers the feasibility of checking for receipt of the related income as a means of establishing ownership. The auditor pays particular attention to establishing the ownership of securities held in bearer form. The auditor also considers whether there are any encumbrances on the title to the securities.

The auditor tests for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.

Valuation

Financial reporting frameworks often prescribe different valuation bases for securities depending on whether they are held for trading purposes, held as portfolio investments, or held for hedging purposes. For example, a financial reporting framework might require trading securities to be carried at market value, portfolio investments at historic cost subject to impairment reviews, and hedging securities on the same basis as the underlying assets they hedge. Management's intentions determine whether any particular security is held for a given purpose, and hence the valuation basis to be used. If management's intentions change, the valuation basis changes too. Accordingly, when securities have been transferred from one category to another, the auditor obtains sufficient appropriate audit evidence to support management's assertions as to their revised intentions. The possibility of changing an asset's categorization provides management with an opportunity for fraudulent financial reporting, as it would be possible to recognize a profit or avoid recognizing a loss by changing the categorization of particular securities.

When securities held for trading purposes are carried at market value, the auditor considers whether securities whose market value has increased have been arbitrarily transferred from Portfolio Investments (see paragraph 87) primarily so that an unrealized gain can be taken into

income.

The auditor also considers whether to reperform the valuation calculations and the extent of tests of the controls over the bank's valuation procedures.

Measurement

The auditor also considers whether:

- The relationship between the types of securities owned and the related income is reasonable; and
- All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).

86. (Those involving current investment of funds, for example, blocks of loans purchased for resale, purchases of securitized assets)

OTHER FINANCIAL ASSETS

Rights and Obligations

The auditor examines the underlying documentation supporting the purchase of such assets in order to determine whether all rights and obligations, such as warranties and options, have been properly accounted for.

Valuation

The auditor considers the appropriateness of the valuation techniques employed. Since there may not be established markets for such assets, it may be difficult to obtain independent evidence of value. Additionally, even where such evidence exists, there may be a question as to whether there is sufficient depth to existing markets to rely on quoted values for the asset in question and for any related offsetting hedge transactions that the bank has entered into in those markets. The auditor also considers the nature and extent of any impairment reviews that management has carried out and whether their results are reflected in the assets' valuations.

- 87.

PORTFOLIO INVESTMENTS

In many cases the audit of a bank's portfolio investments does not differ from the audit of portfolio investments held by any other entity. However, there are some special aspects that pose particular problems in respect of banking operations.

Valuation

The auditor considers the value of the assets supporting the security value, particularly in respect of securities that are not readily marketable. The auditor also considers the nature and extent of any impairment reviews that management has carried out and whether their results are reflected in the assets' valuations.

Measurement

As discussed in paragraph 85, financial reporting frameworks frequently allow different valuation bases for securities held for different purposes. Where securities have been transferred from the Trading Account, the auditor determines whether any unrealized losses in market value are recorded if so required by relevant financial reporting framework. When the financial reporting framework does not require the recording of unrealized losses, the auditor considers whether the transfer was made to avoid the need to recognize reductions in the securities' market value.

The auditor also considers whether:

- The relationship between the types of securities owned and the related income is reasonable; and
- All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).

88. INVESTMENTS IN SUBSIDIARIES AND ASSOCIATED ENTITIES

In many cases the audit of a bank's investments in subsidiaries and associated entities does not differ from the audit of such investments held by any other entity. However, there are some special aspects that pose particular problems in respect of banking operations.

Valuation

The auditor considers the implications of any legal or practical requirement for the bank to provide future financial support to ensure the maintenance of operations (and hence the value of the investment) of subsidiaries and associated companies. The auditor

considers whether the related financial obligations are recorded as liabilities of the bank.

The auditor determines whether appropriate adjustments are made when the accounting policies of companies accounted for on an equity basis or consolidated do not conform to those of the bank.

89. (Comprising advances, bills of exchange, letters of credit, acceptances, guarantees, and all other lines of credit extended to customers, including those in connection with foreign exchange and money market activities)
- Personal
 - Commercial
 - Government
 - Domestic
 - Foreign

LOANS

Existence

The auditor considers the need for external confirmation of the existence of loans.

Valuation

The auditor considers the appropriateness of the provision for loan losses. The auditor understands the laws and regulations that may influence the amounts determined by management. The Basel Committee has published a set of Sound Practices for Loan Accounting and Disclosure, which provides guidance to banks and banking supervisors on recognition and measurement of loans, establishment of loan loss provisions, credit risk disclosure and related matters. It sets out banking supervisors' views on sound loan accounting and disclosure practices for banks and so may influence the financial reporting framework within which a bank prepares its financial statements. However, the bank's financial statements are prepared in accordance with a specified financial reporting framework, and the loan loss provision must be made in accordance with that framework.

Appendix 2 gives further information on the auditor's consideration of loans.

The major audit concern is the adequacy of the recorded provision for loan losses.

In establishing the nature, extent and timing of the work to be performed, the auditor considers the following factors:

- The degree of reliance it is reasonable to place on the bank's system of loan quality classification, on its procedures for ensuring that all documentation is properly completed, on its internal loan review procedures and on the work of internal auditing.

- Given the relative importance of foreign lending, the auditor ordinarily examines:
 - The information on the basis of which the bank assesses and monitors the country risk and the criteria (for example, specific classifications and valuation ratios) it uses for this purpose; and
 - Whether and, if so, by whom credit limits are set for the individual countries, what the limits are and the extent to which they have been reached.
- The composition of the loan portfolio, with particular attention to:
 - The concentration of loans to specific:
- Borrowers and parties connected to them (including the procedures in place to identify such connections);
- Commercial and industrial sectors;
- Geographic regions; and
- Countries;
 - The size of individual credit exposures (few large loans versus numerous small loans);
 - The trends in loan volume by major categories, especially categories having exhibited rapid growth, and in delinquencies, non-accrual and restructured loans; and
 - related party lending.
- Identified potential non-performing loans, with particular attention to:
 - The previous loss and recovery experience, including the adequacy and timeliness of provisions and charge-offs; and
 - Results of regulatory examinations.

Local, national and international economic and environmental conditions, including restrictions on the transfer of foreign currency that may affect the repayment of loans by borrowers.

In addition to those non-performing loans identified by management and, where applicable, by bank regulators, the auditor considers additional sources of information to determine those loans that may not have been so

identified. These include:

- Various internally generated listings, such as “watchlist” loans, past due loans, loans on non-accrual status, loans by risk classification, loans to insiders (including directors and officers), and loans in excess of approved limits;
- Historical loss experience by type of loan; and
- Those loan files lacking current information on borrowers, guarantors or collateral.

Presentation and disclosure

Banks are often subject to particular disclosure requirements concerning their loans and provisions for loan losses. The auditor considers whether the information disclosed is in accordance with the applicable financial or regulatory reporting framework.

90.

ACCOUNTS WITH DEPOSITORS

(a) General deposits

Completeness

The auditor assesses the system of internal control over accounts with depositors. The auditor also considers performing confirmation and analytical procedures on average balances and on interest expense to assess the reasonableness of the recorded deposit balances.

Presentation and Disclosure

The auditor determines whether deposit liabilities are classified in accordance with regulations and relevant accounting principles.

Where deposit liabilities have been secured by specific assets, the auditor considers the need for appropriate disclosure.

The auditor also considers the need for disclosure where the bank has a risk due to economic dependence on a few large depositors or where there is an excessive concentration of deposits due within a specific time.

(b) Items in transit

Existence

The auditor determines whether items in transit between branches, between the bank and its consolidated subsidiaries, and between the bank and counterparties, are eliminated and that reconciling items have been appropriately addressed and accounted for.

Additionally, the auditor examines individual items

comprising the balance that have not been cleared within a reasonable time period and also considers whether the related internal control procedures are adequate to ensure that such items have not been temporarily transferred to other accounts in order to avoid their detection.

91.

CAPITAL AND RESERVES

Banking regulators pay close attention to a bank's capital and reserves in monitoring the level of a bank's activities and in determining the extent of a bank's operations. Small changes in capital or reserves may have a large effect on a bank's ability to continue operating, particularly if it is near to its permitted minimum capital ratios. In such circumstances there are greater pressures for management to engage in fraudulent financial reporting by miscategorizing assets and liabilities or by describing them as being less risky than they actually are.

Presentation and Disclosure

The auditor considers whether capital and reserves are adequate for regulatory purposes (for example, to meet capital adequacy requirements), the disclosures have been appropriately calculated and that the disclosures are both appropriate and in accordance with the applicable financial reporting framework. In many jurisdictions auditors are required to report on a wide range of disclosures about the bank's capital and its capital ratios, either because that information is included in the financial statements or because there is requirement to make a separate report to banking supervisors.

In addition, where applicable regulations provide for restrictions on the distribution of retained earnings, the auditor considers whether the restrictions are adequately disclosed.

The auditor also determines whether the requirements of the applicable financial reporting framework with respect to the disclosure of hidden reserves have been complied with (see also paragraph 103).

92. (For example, commitments to lend funds and to guarantee repayment of funds by customers to third parties)

PROVISIONS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (OTHER THAN DERIVATIVES AND OFF-BALANCE SHEET FINANCIAL INSTRUMENTS)

Completeness

Many contingent assets and liabilities are recorded without there being a corresponding liability or asset (memorandum items). The auditor therefore:

- Identifies those activities that have the potential to generate contingent assets or liabilities (for example, securitizations);
- Considers whether the bank's system of internal control is adequate to ensure that contingent assets or liabilities arising out of such activities are properly identified and recorded and that evidence is retained of the customer's agreement to the related terms and conditions;
- Performs substantive procedures to test the completeness of the recorded assets and liabilities. Such procedures may include confirmation procedures as well as examination of related fee income in respect of such activities and are determined having regard to the degree of risk attached to the particular type of contingency being considered;
- Reviews the reasonableness of the period-end contingent asset and liability figures in the light of the auditor's experience and knowledge of the current year's activities; and
- Obtains representation from management that all contingent assets and liabilities have been recorded and disclosed as required by the financial reporting framework.

Valuation

Many of these transactions are either credit substitutes or depend for their completion on the credit-worthiness of the counterparty. The risks associated with such transactions are in principle no different from those associated with "Loans." The audit objectives and considerations of particular importance discussed in paragraph 89 is equally relevant in respect of these

transactions.

Presentation and Disclosure

Where assets or liabilities have been securitized or otherwise qualify for an accounting treatment that removes them from the bank's balance sheet, the auditor considers the appropriateness of the accounting treatment and whether appropriate provisions have been made. Similarly, where the bank is a counterparty to a transaction that allows a client entity to remove an asset or liability from the client's balance sheet, the auditor considers whether there is any asset or liability that the financial reporting framework requires to be shown in the balance sheet or in the notes to the financial statements.

Although the relevant financial reporting framework ordinarily requires disclosure of such obligations in the notes to the financial statements rather than in the balance sheet, the auditor nevertheless considers the potential financial impact on the bank's capital, funding and profitability of the need to honor such obligations and whether this needs to be specifically disclosed in the financial statements.

93. (For example, foreign exchange contracts, interest rate and currency swaps, futures, options, and forward rate agreements)

DERIVATIVES AND OFF BALANCE SHEET FINANCIAL INSTRUMENTS

Many of these instruments are dealt with as part of the bank's treasury and trading activities. Appendix 2 gives more information on the auditor's consideration of treasury and trading activities. For transactions involving derivatives that the bank enters into as an end user, IAPS 1012 provides further guidance.

Rights and Obligations

The auditor examines the underlying documentation supporting such transactions in order to determine whether all rights and obligations, such as warranties and options, have been properly accounted for.

Existence

The auditor considers the need for third party confirmations of outstanding balances, which are selected from back office records of open transactions and from lists of approved counterparties, brokers and exchanges. It may be necessary to perform confirmation tests separately on the various products as the systems

may not facilitate a combined selection of all transactions with any given counterparty.

Completeness

Due to the continuing development of new financial instruments, there may be a lack of established procedures between participants and within the bank. The auditor therefore assesses the adequacy of the system of internal control, particularly with respect to:

- The adequacy of the procedures and the division of duties regarding the matching of documentation received from counterparties and reconciliation of accounts with counterparties; and
- The adequacy of internal audit review.

The auditor considers assessing the adequacy of the related system of internal control, including regular profit and loss account reconciliations at appropriate intervals and period-end reconciliation procedures, particularly in respect of the completeness and accuracy of the recording of outstanding positions as at the period end. (This requires the auditor to be familiar with standard inter-bank transaction confirmation procedures);

The auditor may also find it useful to examine post period-end transactions for evidence of items that should have been recorded in the year-end financial statements. ISA 560, “Subsequent Events” provides further guidance on the auditor’s consideration of events occurring after the period end.

Valuation

Similar considerations arise here as arise for Other Financial Assets above. However, the following further considerations also arise.

Derivatives and off-balance sheet financial instruments are ordinarily valued at market or fair value, except that, in some financial reporting frameworks, hedging instruments are valued on the same basis as the underlying item being hedged. The applicable financial reporting framework may not require financial instruments to be shown on the balance sheet, or may require them to be valued at cost. In such instances, there may be an obligation to disclose the market or fair values of derivatives or off-balance sheet instruments in the notes to the financial statements.

If the instrument is traded on an investment exchange,

the value may be determined through independent sources. If the transaction is not traded, independent experts may be required to assess the value.

Additionally, the auditor considers the need for and adequacy of fair value adjustments to financial instruments,¹ such as a liquidity risk provision, a modeling risk provision and a provision for operational risk. The auditor considers matters such as the following:

- The appropriateness of the exchange rates, interest rates or other underlying market rates used at the financial statement date to calculate unrealized gains and losses;
- The appropriateness of the valuation models and assumptions used to determine the fair value of financial instruments outstanding as at the financial statement date. In addition, the auditor considers whether details of individual contracts, valuation rates and assumptions used are appropriately entered into the models; and
- The appropriateness of the accounting policies used having regard to relevant accounting principles particularly with regard to the distinction between realized and unrealized profits and losses

When market values need to be considered, but are not available, the auditor considers whether appropriate alternative valuation techniques have been employed, based, where appropriate, on current interest or foreign exchange rates.

As some of these instruments have been developed only recently, the auditor examines their valuation with a special degree of caution, and in doing so bears in mind the following factors.

- There may be no legal precedents concerning the terms of the underlying agreements. This makes it difficult to assess the enforceability of those terms.
- There may be a relatively small number of management personnel who are familiar with the inherent risks of these instruments. This may lead to a higher risk of misstatements occurring and a greater difficulty in establishing controls that would prevent misstatements or detect and correct them on a timely

¹ Where the financial reporting framework is International Financial Reporting Standards, Paragraphs 109–165 of IAS 39 discuss fair value provisions and the treatment of financial assets.

basis.

- Some of these instruments have not existed through a full economic cycle (bull and bear markets, high and low interest rates, high and low trading and price volatility) and it may therefore be more difficult to assess their value with the same degree of certainty as for more established instruments. Similarly, it may be difficult to predict with a sufficient degree of certainty the price correlation with other offsetting instruments used by the bank to hedge its positions.
- The models used for valuing such instruments may not operate properly in abnormal market conditions.

Measurement

The auditor considers the purpose for which the transaction resulting in the instrument was entered into, in particular whether the transaction was a trading transaction or a hedging one. The bank may have been dealing as principal to create a dealing position or to hedge another asset, or it may have been dealing as an intermediary or broker. The purpose may determine the appropriate accounting treatment.

Since settlement of such transactions is at a future date, the auditor considers whether a profit or loss has arisen by the period end that is required to be recorded in the financial statements.

The auditor considers whether there has been a reclassification of hedging and trading transactions/positions that may have been made primarily with a view to taking advantage of differences in the timing of profit and loss recognition.

Presentation and disclosure

In some financial reporting frameworks, the relevant accounting principles require the recording of accrued gains and losses on open positions, whether or not these positions are recorded on the balance sheet. In other financial reporting frameworks there is only an obligation to disclose the commitment. Where the latter is the case, the auditor considers whether the unrecorded amounts are of such significance as to require a disclosure in the financial statements or qualification in the audit report.

The following additional considerations may arise:

- The auditor considers the appropriate accounting treatment and presentation of such transactions in accordance with relevant financial reporting requirements. Where those requirements have different treatments for transactions that are entered into for hedging purposes, the auditor considers whether transactions have been appropriately identified and treated; and
- Some financial reporting frameworks require the disclosure of the potential risk arising from open positions, as for example, the credit risk equivalent and replacement value of outstanding off-balance sheet instruments.

94.

INTEREST INCOME AND INTEREST EXPENSE

Measurement

Interest income and expense ordinarily comprise two of the main items in a bank's income statement. The auditor considers:

- Whether satisfactory procedures exist for the proper accounting of accrued income and expenditure at the year-end;
- Assessing the adequacy of the related system of internal control; and
- Using analytical procedures in assessing the reasonableness of the reported amounts.

Such techniques include comparison of reported interest yields in percentage terms:

- To market rates;
- To central bank rates;
- To advertised rates (by type of loan or deposit); and
- Between portfolios.

In making such comparisons, average rates in effect (for example, by month) are used in order to avoid distortions caused by changes in interest rates.

The auditor considers the reasonableness of the policy applied to income recognition on non-performing loans, especially where such income is not being received on a current basis. The auditor also considers whether income

recognition on non-performing loans complies with the policy of the bank, as well as the requirements of the applicable financial reporting framework.

95.

PROVISIONS FOR LOAN LOSSES

Measurement

The major audit concerns in this area are discussed above under “Loans.” Usually, provisions take two forms, namely specific provisions in respect of identified losses on individual loans and general provisions to cover losses that are thought to exist but have not been specifically identified. The auditor assesses the adequacy of such provisions based on such factors as past experience and other relevant information and considers whether the specific and general provisions are adequate to absorb estimated credit losses associated with the loan portfolio. Appendix 2 to this Statement contains examples of substantive procedures for the evaluation of loan loss provisions. In some countries the levels of general provisions are prescribed by local regulations. In those countries, the auditor determines whether the reported provision expense is calculated in accordance with such regulations. The auditor also considers the adequacy of the disclosures in the financial statements and, when the provisions are not adequate, the implications for the audit report.

96.

FEE AND COMMISSION INCOME

Completeness

The auditor considers whether the amount recorded is complete (that is, all individual items have been recorded). In this respect, the auditor considers using analytical procedures in assessing the reasonableness of the reported amounts.

Measurement

The auditor considers matters such as the following.

- Whether the income relates to the period covered by the financial statements and that those amounts relating to future periods have been deferred.
- Whether the income is collectible (this is considered as part of the loan review audit procedures where the fee has been added to a loan balance outstanding).
- Whether the income is accounted for in accordance with the applicable financial reporting framework.

97. PROVISION FOR TAXES ON INCOME

Measurement

The auditor becomes familiar with the special taxation rules applicable to banks in the jurisdiction in which the bank being reported on is located. The auditor also considers whether any auditors on whose work it is intended to rely in respect of the bank's foreign operations are similarly familiar with the rules in their jurisdiction. The auditor is aware of the taxation treaties between the various jurisdictions in which the bank operates.

98. RELATED PARTY TRANSACTIONS

Presentation and Disclosure

Financial reporting frameworks often require the disclosure of the existence of related parties and of transactions with them. Related party transactions may occur in the ordinary course of a bank's business. For example, a bank may extend credit to its officers or directors or to entities that are owned or controlled by officers or directors. The auditor remains aware of the risk that where such lending transactions with related parties exist, normal measures of banking prudence, such as credit assessment and collateral requirements, may not be exercised properly. The auditor becomes familiar with the applicable regulatory requirements for lending to related parties and performs procedures to identify the bank's controls over related party lending, including approval of related party credit extensions and monitoring of performance of related party loans.

Other related party transactions that may occur in the ordinary course of a bank's business include deposit and other transactions with directors, officers, or affiliated entities. A bank may also guarantee loans to, or the financial performance of, an affiliated entity. The guarantee may be formalized in a written agreement or the guarantee may be informal. Informal guarantees may be oral agreements, "understood" agreements based on the affiliate's historical performance, or the result of the business culture in which the bank operates. Such agreements, whether formal or informal, are of particular concern when the guarantee relates to an unconsolidated affiliate, as the guarantee is not disclosed in the bank's consolidated financial statements. The auditor makes

inquiries of management and reviews the minutes of the board of directors to determine if such guarantees exist and whether there is appropriate disclosure of the guarantees in the bank's financial statements.

Valuation

Related party transactions may also result from management's attempts to avoid adverse circumstances. For example, a bank's management may transfer problem assets to an unconsolidated affiliated entity at or near the period end, or prior to a regulatory examination, to avoid a deficiency in the provision for loan losses or to avoid criticism about asset quality. The auditor considers reviewing transactions involving related parties that have been accounted for as sales transactions to determine whether there are unrecorded recourse obligations involved.

Representations from management or others are often required to understand the business purpose of a particular transaction. Such representations are evaluated in the light of apparent motives and other audit evidence. In order to obtain a complete understanding of a transaction, certain circumstances may warrant a discussion with the related party, their auditor, or other parties such as legal counsel, who are familiar with the transaction. ISA 580, "Management Representations" gives further guidance on the use of management representations.

99.

FIDUCIARY ACTIVITIES

Completeness

The auditor considers whether all the bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also considers whether the bank has incurred any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.

Presentation and Disclosure

The auditor considers whether the financial reporting framework requires disclosure of the nature and extent of its fiduciary activities in the notes to its financial statements, and whether the required disclosures have been made.

- | | |
|--|---|
| 100. (Including, where applicable, a Statement of Accounting Policies) | <p>NOTES TO THE FINANCIAL STATEMENTS</p> <p>Presentation and Disclosure</p> <p>The auditor determines whether the notes to the bank's financial statements are in accordance with the applicable financial reporting framework.</p> |
|--|---|

Reporting on the Financial Statements

101. In expressing an opinion on the bank's financial statements, the auditor:
- Adheres to any specific formats and terminology specified by the law, the regulatory authorities, professional bodies and industry practice; and
 - Determines whether adjustments have been made to the accounts of foreign branches and subsidiaries that are included in the consolidated financial statements of the bank to bring them into conformity with the financial reporting framework under which the bank is reporting. This is particularly relevant in the case of banks because of the large number of countries in which such branches and subsidiaries may be located and the fact that in most countries local regulations prescribe specialized accounting principles applicable primarily to banks. This may lead to a greater divergence in the accounting principles followed by branches and subsidiaries, than is the case in respect of other commercial entities.
102. The financial statements of banks are prepared in the context of the legal and regulatory requirements prevailing in different countries, and accounting policies are influenced by such regulations. In some countries the financial reporting framework for banks (the banking framework) differs materially from the financial reporting framework for other entities (the general framework). When the bank is required to prepare a single set of financial statements that comply with both frameworks, the auditor may express a totally unqualified opinion only if the financial statements have been prepared in accordance with both frameworks. If the financial statements are in accordance with only one of the frameworks, the auditor expresses an unqualified opinion in respect of compliance with that framework and a qualified or adverse opinion in respect of compliance with the other framework. When the bank is required to comply with the banking framework instead of the general framework, the auditor considers the need to refer to this fact in an emphasis of matter paragraph.
103. Banks often present additional information in annual reports that also contain audited financial statements. This information frequently contains details of the bank's risk adjusted capital, and other information relating to the bank's stability, in addition to any disclosures in the financial statements. ISA 720, "Other Information in Documents Containing Audited Financial Statements" provides guidance on the procedures to be undertaken in respect of such additional information.

Appendix 1

Risks and Issues in Respect of Fraud and Illegal Acts

Paragraph 26 of this Statement indicates some of the general considerations in respect of fraud. These are also discussed in more detail in ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements.” ISA 240 requires the auditor to consider whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets. Appendix 1 to the ISA gives an indication of general fraud risk factors: this appendix gives examples of fraud risk factors applicable to banks.

The risk of fraudulent activities or illegal acts arises at banks both from within the institution and from outsiders. Among the many fraudulent activities and illegal acts that banks may face are check-writing fraud, fraudulent lending and trading arrangements, money laundering and misappropriation of banking assets. Fraudulent activities may involve collusion by management of banks and their clients. Those perpetrating fraudulent activities may prepare false and misleading records to justify inappropriate transactions and hide illegal activities. Fraudulent financial reporting is another serious concern.

In addition, banks face an ongoing threat of computer fraud. Computer hackers, and others who may gain unauthorized access to banks computer systems and information databases, can misapply funds to personal accounts and steal private information about the institution and its customers. Also, as is the case for all businesses, fraud and criminal activity perpetrated by authorized users inside banks is a particular concern. Fraud is more likely to be perpetrated at banks that have serious deficiencies in corporate governance and internal control. Significant losses from fraud may arise from the following categories of breakdowns in corporate governance and internal control:

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank. Major losses due to fraud often arise as a consequence of management's lack of attention to, and laxity in, the control culture of the bank, insufficient guidance and oversight by those charged with governance and management, and a lack of clear management accountability through the assignment of roles and responsibilities. These situations also may involve a lack of appropriate incentives for management to carry out strong line supervision and maintain a high level of control consciousness within business areas.
- Inadequate recognition and assessment of the risk of certain banking activities, whether on- or off-balance sheet. When the risks of new products and activities are not adequately assessed and when control systems that function well for simpler traditional products are not updated to address newer complex products, a bank may be exposed to a greater risk of loss from fraud.
- The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating

performance. In particular, the lack of a segregation of duties has played a major role in fraudulent activities that resulted in significant losses at banks.

- Inadequate communication of information between levels of management within the bank, especially in the upward communication of problems. When policies and procedures are not appropriately communicated to all personnel involved in an activity, an environment is created that may foster fraudulent activities. In addition, fraud may go undetected when information about inappropriate activities that should be brought to the attention of higher level management is not communicated to the appropriate level until the problems become severe.
- Inadequate or ineffective internal audit programs and monitoring activities. When internal auditing or other monitoring activities are not sufficiently rigorous to identify and report control weaknesses, fraud may go undetected at banks. When adequate mechanisms are not in place to ensure that management corrects deficiencies reported by auditors, fraud may continue unabated.

The following table and discussion in this appendix provide examples of fraud risk factors.

	Deposit Taking	Dealing	Lending
Management & Employee Fraud	Depositors' camouflage	Off-market rings	Loans to fictitious borrowers
	Unrecorded deposits	Related party deals	Use of nominee companies
	Theft of customer deposits or investments, particularly from dormant accounts	Broker kickbacks	Deposit transformation
		False deals	Transactions with connected companies
		Unrecorded deals	Kickbacks and inducements
		Delayed deal allocations	Use of parallel organizations
		Misuse of discretionary accounts	Funds transformation
		Exploiting weaknesses in matching procedures	Selling recovered collateral at

AUDITS OF THE FINANCIAL STATEMENTS OF BANKS

	Deposit Taking	Dealing	Lending
		Mismarking of book	below market prices
		Collusion in providing valuations (Valuation rings)	Bribes to obtain the release of security or to reduce the amount claimed
		Theft or misuse of collateral held as security	Theft or misuse of collateral held as security
External Fraud	<p>Money laundering</p> <p>Fraudulent instructions</p> <p>Counterfeit currency or drafts</p> <p>Fraudulent use of Check float periods (Check kiting)</p>	<p>Fraudulent custodial sales</p> <p>False information or documents regarding counterparties</p>	<p>Impersonation and false information on loan applications and subsequently provided documents</p> <p>Double-pledging of collateral</p> <p>Fraudulent valuations (Land flips)</p> <p>Forged or valueless collateral</p> <p>Misappropriation of loan funds by agents/ customers</p> <p>Unauthorized sale of collateral</p>

Fraud Risk Factors in Respect of the Deposit Taking Cycle

Depositors' Camouflage

(Hiding the identity of a depositor, possibly in connection with funds transformation or money laundering)

- Similar or like-sounding names across various accounts;
- Offshore company depositors with no clearly defined business or about which there are few details.

Unrecorded Deposits

- Any evidence of deposit-taking by any other company of which there are details on the premises, whether part of the bank or not;
- Documentation held in management offices that it is claimed has no connection with the business of the bank or evasive replies regarding such documents.

Theft of Customer Deposits/Investments

- Customers with hold-mail arrangements who only have very occasional contact with the bank;
- No independent resolution of customer complaints or review of hold-mail accounts.

Fraud Risk Factors in Respect of the Dealing Cycle

Off-Market Rings/Related Party Deals

- No spot checks on the prices at which deals are transacted;
- Unusual levels of activity with particular counterparties.

Broker Kickbacks

- High levels of business with a particular broker;
- Unusual trends in broker commissions.

False Deals

- A significant number of cancelled deals;
- Unusually high value of unsettled transactions.

Unrecorded Deals

- High levels of profit by particular dealers in relation to stated dealing strategy;
- Significant number of unmatched counterparty confirmations.

Delayed Deal Allocations

- No time stamping of deal tickets or a review of the time of booking;
- Alterations to or overwriting of details on deal sheets.

Misuse of Discretionary Accounts

- Unusual trends on particular discretionary accounts;
- Special arrangements for preparation and issue of statements.

Mismarking of the Book

- No detailed valuation policies and guidelines;
- Unusual trends in the value of particular books.

Fraud Risk Factors in Respect of the Lending Cycle

Loans to Fictitious Borrowers/Transactions with Connected Companies

- “Thin” loan files with sketchy, incomplete financial information, poor documentation or management claim the borrower is wealthy and undoubtedly creditworthy;
- Valuations which seem high, valuers used from outside the usually permitted area or the same valuer used on numerous applications;
- Generous extensions or revised terms when the borrower defaults.

Deposit Transformation or Back-to-Back Lending

A bank deposit is made by another bank, which is then used to secure a loan to a beneficiary nominated by the fraudulent staff member of the first bank, who hides the fact that the deposit is pledged.

- Pledges over deposits (disclosed by confirmations which have specifically requested such pledges to be disclosed);
- Documentation of files held in directors’ or senior managers’ offices outside the usual filing areas; deposits continually rolled over or made even when liquidity is tight.

Use of Nominee Companies/Transactions with Connected Companies

- Complex structures which are shrouded in secrecy;
- Several customers with sole contact, that is, handled exclusively by one member of staff;
- Limited liability partnerships without full disclosure of ownership or with complex common ownership structures.

Kickbacks and Inducements

- Excessive amounts of business generated by particular loan officers;

- Strong recommendation by director or lending officer but missing data or documentation on credit file;
- Indications of weak documentation controls, for example providing funding before documentation is complete.

Use of Parallel Organizations

(Companies under the common control of directors/shareholders)

- Unexpected settlement of problem loans shortly before the period end or prior to an audit visit or unexpected new lending close to the period end;
- Changes in the pattern of business with related organizations.

Funds Transformation

(Methods used to conceal the use of bank funds to make apparent loan repayments)

- Loans which suddenly become performing shortly before the period end or prior to an audit visit;
- Transactions with companies within a group or with its associated companies where the business purpose is unclear;
- Lack of cash flow analysis that supports the income generation and repayment ability of the borrower.

Impersonation and False Information on Loan Applications/Double-Pledging of Collateral/Fraudulent Valuations/Forged or Valueless Collateral

- No on-site appraisal of or visit by the borrower;
- Difficulty in obtaining corroboration of the individual's credentials, inconsistent or missing documentation and inconsistencies in personal details;
- Valuer from outside the area in which the property is situated;
- Valuation is ordered and received by the borrower rather than the lender;
- Lack of verification of liens to substantiate lien positions and priorities;
- Lack of physical control of collateral that requires physical possession to secure a loan (for example, jewelry, bearer bonds and art work).

Appendix 2

Examples of Internal Control Considerations and Substantive Procedures for Two Areas of a Bank's Operations:

1. The internal controls and substantive procedures listed below represent neither an exhaustive list of controls and procedures that should be undertaken, nor do they represent any minimum requirement that should be satisfied. Rather, they provide guidance on the controls and procedures that the auditor may consider in dealing with the following areas:
 - (a) Treasury and trading operations; and
 - (b) Loans and advances.

Treasury and Trading Operations

Introduction

2. Treasury operations, in this context, represent all activities relating to the purchase, sale, borrowing and lending of financial instruments. Financial instruments may be securities, money market instruments or derivative instruments. Banks usually enter into such transactions for their own use (for example, for the purpose of hedging risk exposures) or for meeting customers' needs. They also carry out, to a larger or smaller extent, trading activities. Trading may be defined as the purchase and sale (or origination and closing) of financial instruments (including derivatives) with the intention of deriving a gain from the change in market price parameters (for example, foreign exchange rates, interest rates, equity prices) over time. Banks manage and control their treasury activities on the basis of the various risks involved rather than on the basis of the particular type of financial instrument dealt with. The auditor ordinarily adopts the same approach when obtaining audit evidence. IAPS 1012 gives guidance on the audit implications of derivatives acquired by the bank as an end user.

Internal Control Considerations

3. Generally, treasury operations involve transactions that are recorded by IT systems. The risk of processing error in such transactions is ordinarily low provided they are processed by reliable systems. Consequently, the auditor tests whether key processing controls and procedures are operating effectively before assessing the level of inherent and control risks as low. Typical controls in a treasury environment are listed below. These include controls that address business risks of banks and do not necessarily represent controls that address audit risks and that are tested by the auditor in order to assess the levels of inherent and control risks.

Typical Control Questions

Strategic controls

4. Have those charged with governance established a formal policy for the bank's treasury business that sets out:
 - The authorized activities and products the bank can trade on its own or a third party's behalf, ideally broken down by product or risk group;
 - The markets in which trading activities take place: these could be regional markets, or Over-the-Counter ("OTC") versus Exchange markets;
 - The procedures for measuring, analyzing, supervising and controlling risks;
 - The extent of risk positions permissible, after taking into account the risk they regard as acceptable;
 - The appropriate limits and procedures covering excesses over defined limits;
 - The procedures, including documentation, that must be complied with before new products or activities are introduced;
 - The type and frequency of reports to those charged with governance; and
 - The schedule and frequency with which the policy is reviewed, updated and approved?

Operational controls

5. Is there appropriate segregation of duties between the front office and back office?
6. Are the following activities conducted independently of the front office/business unit;
 - Confirmation of trades;
 - Recording and reconciliation of positions and results;
 - Valuation of trades or independent verification of market prices; and
 - Settlement of trades?
7. Are trade tickets pre-numbered (if not automatically generated)?
8. Does the bank have a code of conduct for its dealers that addresses the following:
 - Prohibiting dealers from trading on their own account;
 - Restricting acceptance of gifts and entertainment activities;
 - Confidentiality of customer information;

- Identification of approved counterparties; and
 - Procedures for the review of dealers' activities by management?
9. Are remuneration policies structured to avoid encouraging excessive risk taking?
 10. Are new products introduced only after appropriate approvals are obtained and adequate procedures and risk control systems are in place?

Limits and Trading Activity

11. Does the bank have a comprehensive set of limits in place to control the market, credit and liquidity risks for the whole institution, business units and individual dealers? Some commonly used limits are notional or volume limits (by currency or counterparty), stop loss limits, gap or maturity limits, settlement limits and value-at-risk limits (for both market and credit risks).
12. Are limits allocated to risks in line with the overall limits of the bank?
13. Do all dealers know their limits and the use thereof? Does every new transaction reduce the available limit immediately?
14. Are procedures in place that cover excesses over limits?

Risk Measurement and Management

15. Is there an independent risk management function (sometimes referred to as Middle Office) for measuring, monitoring and controlling risk? Does it report directly to those charged with governance and senior management?
16. Which method is employed to measure the risk arising from trading activities (for example, position limits, sensitivity limits, value at risk limits, etc.)?
17. Are the risk control and management systems adequately equipped to handle the volume, complexity and risk of treasury activities?
18. Does the risk measurement system cover all portfolios, all products and all risks?
19. Is appropriate documentation in place for all elements of the risk system (methodology, calculations, parameters)?
20. Are all trading portfolios revalued and risk exposures calculated regularly, at least daily for active dealing operations?
21. Are risk management models, methodologies and assumptions used to measure risk and to limit exposures regularly assessed, documented and updated continuously to take account of altered parameters, etc?
22. Are stress situations analyzed and "worst case" scenarios (which take into account adverse market events such as unusual changes in prices or volatilities, market illiquidity or default of a major counterparty) conducted and tested?

23. Does management receive timely and meaningful reports?

Confirmations

24. Does the bank have written procedures in use:

- For the independent dispatch of pre-numbered outward confirmations to counterparties for all trades entered into by the dealers;
- For the independent receipt of all incoming confirmations and their matching to pre-numbered copies of internal trade tickets;
- For independent comparison of signatures on incoming confirmations to specimen signatures;
- For the independent confirmation of all deals for which no inward confirmation has been received; and
- For the independent follow-up of discrepancies on confirmations received?

Settlement of transactions

25. Are settlement instructions exchanged in writing with counterparties by the use of inward and outward confirmations?
26. Are settlement instructions compared to the contracts?
27. Are settlements made only by appropriate authorized employees independent of the initiation and recording of transactions and only on the basis of authorized, written instructions?
28. Are all scheduled settlements (receipts and payments) notified daily in writing to the settlement department so that duplicate requests and failures to receive payments can be promptly detected and followed-up?
29. Are accounting entries either prepared from or checked to supporting documentation by operational employees, other than those who maintain records of uncompleted contracts or perform cash functions?

Recording

30. Are exception reports generated for excesses in limits; sudden increases in trading volume by any one trader, customer or counterparty; transactions at unusual contract rates, etc? Are these monitored promptly and independently of the dealers?
31. Does the bank have written procedures that require:
- The accounting for all used and unused trade tickets;
 - The prompt recording into the accounting records by an independent party of all transactions, including procedures to identify and correct rejected transactions;

- The daily reconciliation of dealer's positions and profits with the accounting records and the prompt investigation of all differences; and
 - Regular reports to management in appropriate detail to allow the monitoring of the limits referred to above?
32. Are all *nostro* and *vostro* account reconciliations performed frequently and by employees independent of the settlement function?
33. Are suspense accounts regularly reviewed?
34. Does the bank have an accounting system that allows it to prepare reports that show its spot, forward, net open and overall positions for the different types of products, for example:
- By purchase and sale, by currency;
 - By maturity dates, by currency; and
 - By counterparty, by currency?
35. Are open positions revalued periodically (for example, daily) to current values based on quoted rates or rates obtained directly from independent sources?

General audit procedures

36. Certain audit procedures apply to the environment in which treasury activities are carried out. To understand this environment, the auditor initially obtains an understanding of the:
- Scale, volume, complexity and risk of treasury activities;
 - Importance of treasury activities relative to other business of the bank;
 - Framework within which treasury activities take place; and
 - Organizational integration of the treasury activities.
37. Once the auditor has obtained this understanding and has performed tests of controls with satisfactory results, the auditor ordinarily assesses:
- The accuracy of the recording of transactions entered into during the period and related profits and losses, by reference to deal tickets and confirmation slips;
 - The completeness of transactions and proper reconciliation between the front office and accounting systems of open positions at the period end;
 - The existence of outstanding positions by means of third party confirmations at an interim date or at the period end;
 - The appropriateness of the exchange rates, interest rates or other underlying market rates used at the year end date to calculate unrealized gains and losses;

- The appropriateness of the valuation models and assumptions used to determine the fair value of financial instruments outstanding as at the period end; and
 - The appropriateness of the accounting policies used particularly around income recognition and the distinction between hedged and trading instruments.
38. Relevant aspects of treasury operations that generally pose increased audit risks are addressed below:

Changes in products or activities

39. Particular risks often arise where new products or activities are introduced. To address such risks the auditor initially seeks to confirm that predefined procedures are in place for these cases. Generally, the bank should commence such activities only when the smooth flow of the new transactions through the controls system is ensured, the relevant IT systems are fully in place (or where adequate interim system support is in place) and the relevant procedures are properly documented. Newly traded instruments are ordinarily subject to careful review by the auditor, who initially obtains a list of all new products introduced during the period (or a full list of all instruments transacted). Based on this information, the auditor establishes the associated risk profile and seeks to confirm the reliability of the internal control and accounting systems.

Reliance on computer experts

40. Due to the volume of transactions, virtually all banks support the treasury transactions cycle using IT systems. Due to the complexity of systems in use and the procedures involved, the auditor ordinarily seeks the assistance of IT experts to supply appropriate skills and knowledge in the testing of systems and relevant account balances.

Purpose for which transactions are undertaken

41. The auditor considers whether the bank holds speculative positions in financial instruments or hedges them against other transactions. The purpose for entering such transactions, whether hedging or trading, should be identified at the dealing stage in order for the correct accounting treatment to be applied. Where transactions are entered for hedging purposes, the auditor considers the appropriate accounting treatment and presentation of such transactions and the matched assets/liabilities, in accordance with relevant accounting requirements.

Valuation Procedures

42. Off-balance sheet financial instruments are ordinarily valued at market or fair value, except for instruments used for hedging purposes, which, under many financial reporting frameworks, are valued on the same basis as the underlying item being hedged. Where market prices are not readily available for an instrument, financial models that are widely used by the banking industry may

be used to determine the fair value. In addition to disclosure of the notional amounts of open positions, several countries require the disclosure of the potential risk arising, as for example, the credit risk equivalent and replacement value of such outstanding instruments.

43. The auditor ordinarily tests the valuation models used, including the controls surrounding their operation, and considers whether details of individual contracts, valuation rates and assumptions are appropriately entered into such models. As many of these instruments have been developed only recently, the auditor pays particular attention to their valuation, and in doing so bears in mind the following factors.
 - There may be no legal precedents concerning the terms of the underlying agreements. This makes it difficult to assess the enforceability of those terms.
 - There may be a relatively small number of management personnel who are familiar with the inherent risks of these instruments. This may lead to a higher risk of misstatements occurring and a greater difficulty in establishing controls that would prevent misstatements or detect and correct them on a timely basis.
 - Some of these instruments have not existed through a full economic cycle (bull and bear markets, high and low interest rates, high and low trading and price volatility) and it may therefore be more difficult to assess their value with the same degree of certainty as for more established instruments. Similarly, it may be difficult to predict with a sufficient degree of certainty the price correlation with other offsetting instruments used by the bank to hedge its positions.
 - The models used for valuing such instruments may not operate properly in abnormal market conditions.
44. In addition, the auditor considers the need for, and adequacy of, provisions against financial instruments, such as liquidity risk provision, modeling risk provision and reserve for operational risk. The complexity of certain instruments requires specialist knowledge. If the auditor does not have the professional competence to perform the necessary audit procedures, advice is sought from appropriate experts.
45. A further issue of particular interest to the auditor is transactions entered into at rates outside the prevailing market rates; these often involve the risk of hidden losses or fraudulent activity. As a result, the bank ordinarily provides mechanisms that are capable of detecting transactions out of line with market conditions. The auditor obtains sufficient appropriate audit evidence concerning the reliability of the function performing this task. The auditor also considers reviewing a sample of the identified transactions.

*Loans and Advances***Introduction**

46. According to a consultative paper, “Principles for the Management of Credit Risk”, issued by the Basel Committee on Banking Supervision, credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.
47. Loans and advances are the primary source of credit risk for most banks, because they usually are a bank’s most significant assets and generate the largest portion of revenues. The overriding factor in making a loan is the amount of credit risk associated with the lending process. For individual loans, credit risk pertains to the borrower’s ability and willingness to pay. Aside from loans, other sources of credit risk include acceptances, inter-bank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.
48. Credit risk represents a major cause of serious banking problems, and is directly related to lax credit standards for borrowers and counterparties, lack of qualified lending expertise, poor portfolio risk management, and a lack of attention to changes in economic or other circumstances that may lead to a deterioration in the credit standing of a bank’s counterparties. Effective credit risk management is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization. In managing credit risk, banks should consider the level of risk inherent in both individual credits or transactions and in the entire asset portfolio. Banks also need to analyze the risk between credit risk and other risks.

Typical Control Questions

49. Credit risks arise from characteristics of the borrower and from the nature of the exposure. The creditworthiness, country of operation and nature of borrower’s business affect the degree of credit risk. Similarly, the credit risk is influenced by the purpose and security for the exposure.
50. The credit function may conveniently be divided into the following categories:
 - (a) Origination and disbursement;
 - (b) Monitoring;
 - (c) Collection; and
 - (d) Periodic review and evaluation.

Origination and disbursement

51. Does the bank obtain complete and informative loan applications, including financial statements of the borrower, the source of the loan repayment and the intended use of proceeds?
52. Does the bank have written guidelines as to the criteria to be used in assessing loan applications (for example, interest coverage, margin requirements, debt-to-equity ratios)?
53. Does the bank obtain credit reports or have independent investigations conducted on prospective borrowers?
54. Does the bank have procedures in use to ensure that related party lending has been identified?
55. Is there an appropriate analysis of customer credit information, including projected sources of loan servicing and repayments?
56. Are loan approval limits based on the lending officer's expertise?
57. Is appropriate lending committee or board of director approval required for loans exceeding prescribed limits?
58. Is there appropriate segregation of duties between the loan approval function and the loan disbursement monitoring, collection and review functions?
59. Is the ownership of loan collateral and priority of the security interest verified?
60. Does the bank ensure that the borrower signs a legally enforceable document as evidence of an obligation to repay the loan?
61. Are guarantees examined to ensure that they are legally enforceable?
62. Is the documentation supporting the loan application reviewed and approved by an employee independent of the lending officer?
63. Is there a control to ensure the appropriate registration of security (for example, recording of liens with governmental authorities)?
64. Is there adequate physical protection of notes, collateral and supporting documents?
65. Is there a control to ensure that loan disbursements are recorded immediately?
66. Is there a control to ensure that to the extent possible, loan proceeds are used by the borrower for the intended purpose?

Monitoring

67. Are trial balances prepared and reconciled with control accounts by employees who do not process or record loan transactions?
68. Are reports prepared on a timely basis of loans on which principal or interest payments are in arrears?

69. Are these reports reviewed by employees independent of the lending function?
70. Are there procedures in use to monitor the borrower's compliance with any loan restrictions (for example, covenants) and requirements to supply information to the bank?
71. Are there procedures in place that require the periodic reassessment of collateral values?
72. Are there procedures in place to ensure that the borrower's financial position and results of operations are reviewed on a regular basis?
73. Are there procedures in place to ensure that key administrative dates, such as the renewal of security registrations, are accurately recorded and acted upon as they arise?

Collection

74. Are the records of principal and interest collections and the updating of loan account balances maintained by employees independent of the credit granting function?
75. Is there a control to ensure that loans in arrears are followed up for payment on a timely basis?
76. Are there written procedures in place to define the bank's policy for recovering outstanding principal and interest through legal proceedings, such as foreclosure or repossession?
77. Are there procedures in place to provide for the regular confirmation of loan balances by direct written communication with the borrower by employees independent of the credit granting and loan recording functions, as well as the independent investigation of reported differences?

Periodic review and evaluation

78. Are there procedures in place for the independent review of all loans on a regular basis, including:
 - The review of the results of the monitoring procedures referred to above; and
 - The review of current issues affecting borrowers in relevant geographic and industrial sectors?
79. Are there appropriate written policies in effect to establish the criteria for:
 - The establishment of loan loss provisions;
 - The cessation of interest accruals (or the establishment of offsetting provisions);
 - The valuation of collateral security for loss provisioning purposes;
 - The reversals of previously established provisions;

- The resumption of interest accruals; and
 - The writing off of loans?
80. Are there procedures in place to ensure that all required provisions are entered into the accounting records on a timely basis?

General Audit Procedures

81. The following audit procedures are intended to allow the auditor to discover the operating standards and processes that the bank has established and to consider whether controls regarding credit risk management are adequate.

Planning

82. The auditor obtains a knowledge and understanding of the bank's method of controlling credit risk. This includes matters such as the following:
- The bank's exposure monitoring process, and its system for ensuring that all connected party lending has been identified and aggregated;
 - The bank's method for appraising the value of exposure collateral and for identifying potential and definite losses; and
 - The bank's lending practices and customer base.
83. The auditor considers whether the exposure review program ensures independence from the lending functions including whether the frequency is sufficient to provide timely information concerning emerging trends in the portfolio and general economic conditions and whether the frequency is increased for identified problem credits.
84. The auditor considers the qualifications of the personnel involved in the credit review function. The industry is changing rapidly and fundamentally creating a lack of qualified lending expertise. The auditor considers whether credit review personnel possess the knowledge and skills necessary to manage and evaluate lending activities.
85. The auditor considers, through information previously generated, the causes of existing problems or weaknesses within the system. The auditor considers whether these problems or weaknesses present the potential for future problems.
86. The auditor reviews management reports and considers whether they are sufficiently detailed to evaluate risk factors.
87. Note that defining and auditing related party lending transactions are difficult because the transactions with related parties are not easily identifiable. Reliance is primarily upon management to identify all related parties and related-party transactions and such transactions may not be easily detected by the bank's internal control systems.

Tests of Control

88. The auditor obtains a knowledge and understanding of the bank's method of controlling credit risk. This includes matters such as:
 - The exposure portfolio and the various features and characteristics of the exposures;
 - The exposure documentation used by the bank;
 - What constitutes appropriate exposure documentation for different types of exposures; and
 - The bank's procedures and authority levels for granting an exposure.
89. The auditor reviews the lending policies and considers:
 - Whether the policies are reviewed and updated periodically to ensure they are relevant with changing market conditions and new business lines of the bank; and
 - Whether those charged with governance have approved the policies and whether the bank is in compliance.
90. The auditor examines the exposure review reporting system, including credit file memoranda and an annual schedule or exposure review plan, and considers whether it is thorough, accurate and timely and whether it will provide sufficient information to allow management to both identify and control risk. Do the reports include:
 - Identification of problem credits;
 - Current information regarding portfolio risk; and
 - Information concerning emerging trends in the portfolio and lending areas?
91. The auditor considers the nature and extent of the scope of the exposure review, including:
 - Method of exposure selection.
 - Manner in which exposures are reviewed including:

An analysis of the current financial condition of the borrower which addresses repayment ability, and

Tests for documentation exceptions, policy exceptions, noncompliance with internal procedures, and violations of laws and regulations
92. The auditor considers the effectiveness of the credit administration and portfolio management by examining:
 - Management's general lending philosophy in such a manner as to elicit management responses.

- The effect of credits not supported by current and complete financial information and analysis of repayment ability.
- The effect of credits for which exposure and collateral documentation are deficient
- The volume of exposures improperly structured, for example, where the repayment schedule does not match exposure purpose.
- The volume and nature of concentrations of credit, including concentrations of classified and criticized credits.
- The appropriateness of transfers of low quality credits to or from another affiliated office.
- The accuracy and completeness of reports.
- Competency of senior management, exposure officers and credit administration personnel.

Substantive Procedures

93. The auditor considers the extent of management's knowledge of the bank's own credit exposure problems through selective exposure file reviews. Selection criteria include the following:
 - Accounts with an outstanding balance equal to or greater than a specified amount;
 - Accounts on a "Watch List" with an outstanding balance in excess of a specified amount;
 - Accounts with a provision in excess of a specified amount;
 - Accounts that are handled by the department that manages the bank's problem or higher risk accounts;
 - Accounts where principal or interest of more than a specified amount is in arrears for more than a specified period;
 - Accounts where the amount outstanding is in excess of the authorized credit line;
 - Accounts with entities operating in industries or countries that the auditor's own general economic knowledge indicates could be at risk;
 - Problem accounts identified by the bank regulatory authorities and problem accounts selected in the prior year; and
 - The extent of exposure to other financial institutions on inter-bank lines.
94. In addition, where the bank's personnel have been requested to summarize characteristics of all exposures over a specified size grouped on a connection basis, the auditor reviews the summaries. Exposures with the following characteristics may indicate a need for a more detailed review:

- Large operating loss in the most recent fiscal year;
 - Sustained operating losses (for example, 2 or more years);
 - A high debt/equity ratio (for example, in excess of 2:1—the ratio will vary by industry);
 - Failure to comply with terms of agreement on covenants;
 - Modified audit report;
 - Information provided not current or complete;
 - Advances significantly unsecured or secured substantially by a guarantee; and
 - Accounts where reviews not performed by bank management on a timely basis.
95. The auditor selects the exposures for detailed review from the exposure listings above using the sample selection criteria determined above and obtains the documents necessary to consider the collectability of the exposures. These may include:
- The exposure and security documentation files;
 - Arrears listings or reports;
 - Activity summaries;
 - Previous doubtful accounts listings;
 - The non-current exposure report;
 - Financial statements of the borrower; and
 - Security valuation reports.
96. Using the exposure documentation file, the auditor:
- Ascertains the exposure type, interest rate, maturity date, repayment terms, security and stated purpose of the exposure.
 - Considers whether security documents bear evidence of registration as appropriate, and that the bank has received appropriate legal advice about the security's legal enforceability.
 - Considers whether the fair value of the security appears adequate (particularly for those exposures where a provision may be required) to secure the exposure and that where applicable, the security has been properly insured. Critically evaluates the collateral appraisals, including the appraiser's methods and assumptions.
 - Evaluates the collectability of the exposure and considers the need for a provision against the account.

- Determines whether the appropriate authority levels within the bank have approved the exposure application or renewal.
 - Reviews periodic financial statements of the borrower and notes significant amounts and operating ratios (that is, working capital, earnings, shareholders' equity and debt-to-equity ratios).
 - Reviews any notes and correspondence contained in the exposure review file. Notes the frequency of review performed by the bank's staff and considers whether it is within bank guidelines.
97. The auditor considers whether policies and procedures exist for problem and workout exposures, including:
- A periodic review of individual problem credits.
 - Guidelines for collecting or strengthening the exposure, including requirements for updating collateral values and lien positions, documentation review, officer call reports.
 - Volume and trend of past due and non-accrual credits.
 - Qualified officers handling problem exposures.
 - Guidelines on proper accounting for problem exposures, for example, non-accrual policy, specific reserve policy.
98. In addition to assessing the adequacy of the provisions against individual exposures, the auditor considers whether any additional provisions need to be established against particular categories or classes of exposures (for example, credit card exposures and country risk exposures) and assesses the adequacy of any provisions that the bank may have established through discussions with management.

Appendix 3

Examples of Financial Information, Ratios and Indicators Commonly Used in the Analysis of a Bank's Financial Condition and Performance

There are a large number of financial ratios that are used to analyze a bank's financial condition and performance. While these ratios vary somewhat between countries and between banks, their basic purpose tends to remain the same, that is, to provide measures of performance in relation to prior years, to budget and to other banks. The auditor considers the ratios obtained by one bank in the context of similar ratios achieved by other banks for which the auditor has, or may obtain, sufficient information.

These ratios generally fall into the following categories:

- Asset quality;
- Liquidity;
- Earnings;
- Capital adequacy;
- Market risk; and
- Funding risk.

Set out below are those overall ratios that the auditor is likely to encounter. Many other, more detailed ratios are ordinarily prepared by management to assist in the analysis of the condition and performance of the bank and its various categories of assets and liabilities, departments and market segments.

(a) Asset quality ratios:

- Loan losses to total loans
- Non-performing loans to total loans
- Loan loss provisions to non-performing loans
- Earnings coverage to loan losses
- Increase in loan loss provisions to gross income
- Size, credit risk concentration, provisioning

(b) Liquidity ratios:

- Cash and liquid securities (for example, those due within 30 days) to total assets
- Cash, liquid securities and highly marketable securities to total assets
- Inter-bank and money market deposit liabilities to total assets

(c) Earnings ratios:

- Return on average total assets
- Return on average total equity
- Net interest margin as a percentage of average total assets and average earning assets
- Interest income as a percentage of average interest bearing assets
- Interest expense as a percentage of average interest bearing liabilities
- Non-interest income as a percentage of average commitments
- Non-interest income as a percentage of average total assets
- Non-interest expense as a percentage of average total assets
- Non-interest expense as a percentage of operating income

(d) Capital adequacy ratios:

- Equity as a percentage of total assets
- Tier 1 capital as a percentage of risk-weighted assets
- Total capital as a percentage of risk-weighted assets

(e) Market risk:

- Concentration of risk of particular industries or geographic areas
- Value at risk
- Gap and duration analysis (basically a maturity analysis and the effect of changes in interest rates on the bank's earnings or own funds)
- Relative size of engagements and liabilities
- Effect of changes in interest rates on the bank's earnings or own funds

(f) Funding risk:

- Clients' funding to total funding (clients' plus interbank)
- Maturities
- Average borrowing rate

Appendix 4

Risks and Issues in Securities Underwriting and Securities Brokerage

Securities Underwriting

Many banks provide such financial services as underwriting publicly offered securities or assisting in the private placement of securities. Banks engaging in these activities may be exposed to substantial risks that have audit implications. These activities and the risks associated with them are quite complex, and consideration is given to consulting with experts in such matters.

The type of security being underwritten, as well as the structure of the offering, influence the risks present in securities underwriting activities. Depending upon how a security offering is structured, an underwriter may be required to buy a portion of the positions offered. This creates the need to finance the unsold portions, and exposes the entity to the market risk of ownership.

There is also a significant element of legal and regulatory risk that is driven by the jurisdiction in which the security offering is taking place. Examples of legal and regulatory risk areas include an underwriter's exposure for material misstatements included in a securities registration or offering statement and local regulations governing the distribution and trading in public offerings. Also included are risks arising from insider trading and market manipulation by management or the bank's staff. Private placements are ordinarily conducted on an agency basis and therefore result in less risk than that associated with a public offering of securities. However, the auditor considers local regulations covering private placements.

Securities Brokerage

Many banks also are involved in securities brokerage activities that include facilitating customers' securities transactions. As with securities underwriting, banks engaging in these activities (as a broker, dealer, or both) may be exposed to substantial risks that have audit implications. These activities and the risks associated with them are quite complex, and consideration is given to consulting with experts in such matters.

The types of services offered to customers and the methods used to deliver them determine the type and extent of risks present in securities brokerage activities. The number of securities exchanges on which the bank conducts business and executes trades for its customers also influences the risk profile. One service often offered is the extension of credit to customers who have bought securities on margin, resulting in credit risk to the bank. Another common service is acting as a depository for securities owned by customers. Entities are also exposed to liquidity risks associated with funding securities brokerage operations. The related audit risk factors are similar to those set out in Appendix 5 "Risks and Issues in Asset Management."

There is also a significant element of legal and regulatory risk that is driven by the jurisdiction in which the security brokerage activities are taking place. This may be a consideration for regulatory reporting by the bank, reports directly by the auditor to regulators and also from the point of view of reputation and financial risk that may occur in the event of regulatory breaches by the bank.

Appendix 5

Risks and Issues in Private Banking and Asset Management

Private Banking

Provision of superior levels of banking services to individuals, typically people with high net worth, is commonly known as private banking. Such individuals may often be domiciled in a country different from that of the bank. Before auditing private banking activities, the auditor understands the basic controls over these activities. The auditor considers the extent of the entity's ability to recognize and manage the potential reputational and legal risks that may be associated with inadequate knowledge and understanding of its clients' personal and business backgrounds, sources of wealth, and uses of private banking accounts. The auditor considers the following.

- Whether management oversight over private banking activities includes the creation of an appropriate corporate culture. Additionally, high levels of management should set goals and objectives and senior management must actively seek compliance with corporate policies and procedures.
- Policies and procedures over private banking activities should be in writing and should include sufficient guidance to ensure there is adequate knowledge of the entity's customers. For example, the policies and procedures should require that the entity obtain identification and basic background information on their clients, describe the clients' source of wealth and lines of business, request references, handle referrals, and identify suspicious transactions. The entity should also have adequate written credit policies and procedures that address, among other things, money laundering related issues, such as lending secured by cash collateral.
- Risk management practices and monitoring systems should stress the importance of the acquisition and retention of documentation relating to clients, and the importance of due diligence in obtaining follow-up information where needed to verify or corroborate information provided by a customer or his or her representative. Inherent in sound private banking operations is the need to comply with any customer identification requirements. The information systems should be capable of monitoring all aspects of an entity's private banking activities. These include systems that provide management with timely information necessary to analyze and effectively manage the private banking business, and systems that enable management to monitor accounts for suspicious transactions and to report any such instances to law enforcement authorities and banking supervisors as required by regulations or laws.

The auditor considers the assessed levels of inherent and control risk related to private banking activities when determining the nature, timing and extent of substantive procedures. The following list identifies many of the common audit risk factors to consider when determining the nature, timing and extent of procedures to be performed.

Since private banking frequently involves asset management activities the audit risk factors associated with asset management activities are also included below.

- *Compliance with regulatory requirements.* Private banking is highly regulated in many countries. This may be a consideration for regulatory reporting by the client, reports directly by the auditor to regulators and also from the point of view of the reputation and financial risk that may occur in the event of regulatory breaches by the bank. Also, the nature of private banking activities may increase the bank's susceptibility to money laundering, and thus may have increased operational, regulatory, and reputational risks, which may have audit implications.
- *Confidentiality.* This is generally a feature of private banking. In addition to the normal secrecy which most countries accord bank/client relationships, many jurisdictions where private banking is common have additional banking secrecy legislation which may reduce the ability of regulators, taxing authorities or police, from their own or other jurisdictions, to access client information. A bank may seek to impose restrictions on an auditor's access to the names of the bank's private clients, affecting the auditor's ability to identify related party transactions. A related issue is that the bank may be requested by a client not to send correspondence, including account statements ("hold mail accounts"). This may reduce the auditor's ability to gain evidence as to completeness and accuracy and, in the absence of adequate alternative procedures, the auditor considers the implications of this for the auditor's report.
- *Management fraud.* The tight confidentiality and personal nature of private banking relationships may reduce the effectiveness of internal controls that provide supervision and oversight over staff who deal with private clients' affairs. The high degree of personal trust that may exist between a client and their private banker may add to the risk in that many private bankers are given some degree of autonomy over the management of their clients' affairs. This risk is exacerbated to the extent private clients may not be in a position to verify their affairs on a regular basis as explained above.
- *Services designed to legally transfer some degree of ownership/control of assets to third parties, including trusts and other similar legal arrangements.* Such arrangements are not confined to private banking relationships, however, they are commonly present in them. For the bank, the risk is that the terms of the trust or other legal arrangement are not complied with or do not comply with the applicable law. This exposes the bank to possible liability to the beneficiaries. Controls in this area are particularly important, given that errors are often identified only when the trust or other arrangement is wound up, possibly decades after its creation. Private bankers often are also involved in preparing wills or other testamentary documents, and act as executors. Improper drafting of a will may carry financial consequences to the bank. Controls should exist in this area and in the area of monitoring executor activity. The auditor considers whether there are any undisclosed liabilities in respect of such services. Confidentiality requirements may affect the auditor's ability to obtain sufficient appropriate audit evidence, and if so, the auditor considers the implications for the auditor's report. Finally, trust and similar

arrangements provided by private banks are often outsourced to third parties. The auditor considers what audit risk factors remain for outsourced services, the procedures needed to understand the risks and relationships and assess the controls over and within the outsourced service provider.

- *Credit risk.* Credit risk is often more complex when private banking services are provided because of the nature of their customers' borrowing requirements. The following services often make credit risk difficult to judge: structured facilities (credit transactions with multiple objectives which address client requirements in areas such as tax, regulation, hedging, etc.); unusual assets pledged as security (for example, art collections, not readily saleable properties, intangible assets whose value is reliant on future cash flows); and reliance placed on personal guarantees ("name lending").
- *Custody.* Private banks may offer custodial services to clients for physical investment assets or valuables. The related audit risk factors are similar to those set out below under Asset Management.

Asset Management

The following risk factors are provided as considerations in planning the strategy and execution of the audit of a bank's asset management activities. Included in this area are fund management, pension management, vehicles designed to legally transfer some degree of ownership/control of assets to third parties such as trusts or other similar arrangements etc. This list is not exhaustive as the financial services industry is a rapidly changing industry.

- *When both the asset manager and the assets themselves are not both audited by the same audit firm.* The performance of an asset manager and the assets themselves generally are closely linked. It is easier to identify and understand the implications of an issue arising in one entity on the financial statements of the other if both are audited by the same firm, or if arrangements have been made to permit an appropriate exchange of information between two audit firms. Where there is no requirement for both the assets and the asset manager to be audited, or where appropriate access to the other audit firm is not possible, the auditor considers whether he is in a position to form a complete view.
- *Fiduciary responsibility to third parties.* Mismanagement of third party funds may have a financial or reputational effect on an asset manager. Matters falling into this category may include:
 - Improper record keeping;
 - Inadequate controls over the protection and valuation of assets;
 - Inadequate controls to prevent fund manager fraud;
 - Inappropriate physical and/or legal segregation of client funds from the manager's funds or other clients' funds (often a regulated aspect);

- Inappropriate segregation of client investments from the manager's own investments (either personal or corporate or both) or other clients' investments;
 - Inappropriate segregation of bank staff engaged in asset management duties and those engaged in other operations;
 - Non-compliance with mandates from clients or the investment policy under which funds were supposed to be managed; and
 - Failure to comply with reporting requirements (contractual or regulatory) to clients.
- Consideration is given to the policies and controls over client acceptance; investment decisions; compliance with client instructions; conflicts of interest; compliance with regulations; segregation and safeguarding of funds and proper reporting of client assets and transactions.
 - *Fund manager remuneration.* There is a heightened potential for fund managers to make imprudent or illegal business decisions based upon a desire for personal gain through a bonus or incentive arrangement.
 - *Technology.* Technology is critical to the operation of most asset management companies therefore an examination is made of the security, completeness and accuracy of data and data input where computer controls are being relied on for audit purposes, as well as the overall computer control environment. Consideration is given as to whether appropriate controls exist to ensure transactions on behalf of clients are separately recorded from the bank's own transactions.
 - *Globalization and international diversification.* These are features of many asset managers and this may give rise to additional risks due to the diversity of practice among different countries regarding matters such as pricing and custody rules, regulations, legal systems, market practices, disclosure rules and accounting standards.

Glossary of Terms

Hidden Reserves	Some financial reporting frameworks allow banks to manipulate their reported income by transferring amounts to non-disclosed reserves in years when they make large profits and transferring amounts from those reserves when they make losses or small profits. The reported income is the amount after such transfers. The practice served to make the bank appear more stable by reducing the volatility of its earnings, and would help to prevent a loss of confidence in the bank by reducing the occasions on which it would report low earnings.
Nostros	Accounts held in the bank's name with a correspondent bank.
Provision	An adjustment to the carrying value of an asset to take account of factors that might reduce the asset's worth to the entity. Sometimes called an allowance.
Prudential Ratios	Ratios used by regulators to determine the types and amounts of lending a bank can undertake.
Stress Testing	Testing a valuation model by using assumptions and initial data outside normal market circumstances and assessing whether the model's predictions are still reliable.
Vostros	Accounts held by the bank in the name of a correspondent bank.

Reference Material

The following is a list of material that auditors of banks' financial statements may find helpful.

Basel Committee on Banking Supervision:

Publication 30: Core Principles for Effective Banking Supervision. Basel, 1997.

Publication 33: Framework for Internal Control Systems in Banking Organisations. Basel, 1998.

Publication 55: Sound Practices for Loan Accounting and Disclosure. Basel, 1999.

Publication 56: Enhancing Corporate Governance in Banking Organisations. Basel, 1999.

Publication 72: Internal Audit in Banking Organisations and the Relationship of the Supervisory Authorities with Internal and External Auditors. Basel, 2000

Publication 75: Principles for the Management of Credit Risk. Basel, 2000.

Publication 77: Customer Due Diligence for Banks. Basel, 2001.

Publication 82: Risk Management Principles for Electronic Banking. Basel, 2001.

Publications of the Basel Committee on Banking Supervision can be downloaded from the web site of the Bank for International Settlements: <http://www.bis.org>.

International Accounting Standards Board:

IAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions. London, 1999.

IAS 32: Financial Instruments: Disclosure and Presentation. London, 2000.

IAS 37: Provisions, Contingent Liabilities and Contingent Assets. London, 1998.

IAS 39: Financial Instruments: Recognition and Measurement. London, 2000.

In addition a number of IFAC member bodies have issued reference and guidance material on banks and the audits of the financial statements of banks.

**INTERNATIONAL AUDITING
PRACTICE STATEMENT 1008**

**RISK ASSESSMENTS AND INTERNAL CONTROL—CIS
CHARACTERISTICS AND CONSIDERATIONS**

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International Auditing Practices Committee approved this International Auditing Practice Statement for publication in October 1991.

The auditor should understand and consider the characteristics of the CIS environment because they affect the design of the accounting system and related internal controls, the selection of internal controls upon which the auditor intends to rely, and the nature, timing and extent of the procedures.

This Statement is issued as a supplement to ISA 400 “Risk Assessments and Internal control.” It does not form a part of the ISA, and is not intended to have the authority of an ISA.

Introduction

1. A computer information systems (CIS)¹ environment is defined in International Standard on Auditing (ISA) 401 “Auditing in a Computer Information Systems Environment,” as follows:

For purposes of International Standards on Auditing, a CIS environment exists when a computer of any type or size is involved in the processing by the entity of financial information of significance to the audit, whether that computer is operated by the entity or by a third party.

The introduction of all desired CIS controls may not be practicable when the size of the business is small or when microcomputers are used irrespective of the size of the business. Also, where data is processed by a third party, the consideration of the CIS environment characteristics may vary depending on the degree of access to third party processing. A series of International Auditing Practice Statements has been developed to supplement the following paragraphs. This series describes various CIS environments and their effect on the accounting and internal control systems and on auditing procedures.

Organizational Structure

2. In a CIS environment, an entity will establish an organizational structure and procedures to manage the CIS activities. Characteristics of a CIS organizational structure include:
 - (a) Concentration of functions and knowledge—although most systems employing CIS methods will include certain manual operations, generally the number of persons involved in the processing of financial information is significantly reduced. Furthermore, certain data processing personnel may be the only ones with a detailed knowledge of the interrelationship between the source of data, how it is processed and the distribution and use of the output. It is also likely that they are aware of any internal control weaknesses and, therefore, may be in a position to alter programs or data while stored or during processing. Moreover, many conventional controls based on adequate segregation of incompatible functions may not exist, or in the absence of access and other controls, may be less effective.
 - (b) Concentration of programs and data—transaction and master file data are often concentrated, usually in machine-readable form, either in one computer installation located centrally or in a number of installations distributed throughout an entity. Computer programs which provide the ability to obtain access to and alter such data are likely to be stored at the same location as the data. Therefore, in the absence of appropriate

¹ This term is used throughout this Statement in place of electronic data processing (EDP) used in prior Statement “Risk Assessments and Internal Control—EDP Characteristics and Considerations.”

controls, there is an increased potential for unauthorized access to, and alteration of, programs and data.

Nature of Processing

3. The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. In addition, these systems may be accessible by a larger number of persons. System characteristics that may result from the nature of CIS processing include:
 - (a) *Absence of input documents*—data may be entered directly into the computer system without supporting documents. In some on-line transaction systems, written evidence of individual data entry authorization (e.g., approval for order entry) may be replaced by other procedures, such as authorization controls contained in computer programs (e.g., credit limit approval).
 - (b) *Lack of visible transaction trail*—certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In a CIS environment, however, the transaction trail may be partly in machine-readable form, and furthermore it may exist only for a limited period of time.
 - (c) *Lack of visible output*—certain transactions or results of processing may not be printed. In a manual system, and in some CIS, it is normally possible to examine visually the results of processing. In other CIS, the results of processing may not be printed, or only summary data may be printed. Thus, the lack of visible output may result in the need to access data retained on files readable only by the computer.
 - (d) *Ease of access to data and computer programs*—data and computer programs may be accessed and altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and alteration of, data and programs by persons inside or outside the entity.

Design and Procedural Aspects

4. The development of CIS will generally result in design and procedural characteristics that are different from those found in manual systems. These different design and procedural aspects of CIS include:
 - (a) *Consistency of performance*—CIS perform functions exactly as programmed and are potentially more reliable than manual systems, provided that all transaction types and conditions that could occur are anticipated and incorporated into the system. On the other hand, a computer program that is not correctly programmed and tested may consistently process transactions or other data erroneously.

- (b) *Programmed control procedures*—the nature of computer processing allows the design of internal control procedures in computer programs. These procedures can be designed to provide controls with limited visibility (e.g., protection of data against unauthorized access may be provided by passwords). Other procedures can be designed for use with manual intervention, such as review of reports printed for exception and error reporting, and reasonableness and limit checks of data.
- (c) *Single transaction update of multiple or data base computer files*—a single input to the accounting system may automatically update all records associated with the transaction (e.g., shipment of goods documents may update the sales and customers' accounts receivable files as well as the inventory file). Thus, an erroneous entry in such a system may create errors in various financial accounts.
- (d) *Systems generated transactions*—certain transactions may be initiated by the CIS itself without the need for an input document. The authorization of such transactions may not be evidenced by visible input documentation nor documented in the same way as transactions which are initiated outside the CIS (e.g., interest may be calculated and charged automatically to customers' account balances on the basis of pre-authorized terms contained in a computer program).
- (e) *Vulnerability of data and program storage media*—large volumes of data and the computer programs used to process such data may be stored on portable or fixed storage media, such as magnetic disks and tapes. These media are vulnerable to theft, loss, or intentional or accidental destruction.

Internal Controls in a CIS Environment

5. The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programs. Such manual and computer control procedures comprise the overall controls affecting the CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS Controls

6. The purpose of general CIS controls is to establish a framework of overall control over the CIS activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved. General CIS controls may include:
 - (a) *Organization and management controls*—designed to establish an organizational framework over CIS activities, including:
 - Policies and procedures relating to control functions.

- Appropriate segregation of incompatible functions (e.g., preparation of input transactions, programming and computer operations).
- (b) *Application systems development and maintenance controls*—designed to provide reasonable assurance that systems are developed and maintained in an authorized and efficient manner. They also typically are designed to establish control over:
 - Testing, conversion, implementation and documentation of new or revised systems.
 - Changes to application systems.
 - Access to systems documentation.
 - Acquisition of application systems from third parties.
- (c) *Computer operation controls*—designed to control the operation of the systems and to provide reasonable assurance that:
 - The systems are used for authorized purposes only.
 - Access to computer operations is restricted to authorized personnel.
 - Only authorized programs are used.
 - Processing errors are detected and corrected.
- (d) *Systems software controls*—designed to provide reasonable assurance that system software is acquired or developed in an authorized and efficient manner, including:
 - Authorization, approval, testing, implementation and documentation of new systems software and systems software modifications.
 - Restriction of access to systems software and documentation to authorized personnel.
- (e) *Data entry and program controls*—designed to provide reasonable assurance that:
 - An authorization structure is established over transactions being entered into the system.
 - Access to data and programs is restricted to authorized personnel.
- 7. There are other CIS safeguards that contribute to the continuity of CIS processing. These may include:
 - Offsite back-up of data and computer programs.
 - Recovery procedures for use in the event of theft, loss or intentional or accidental destruction.
 - Provision for offsite processing in the event of disaster.

CIS Application Controls

8. The purpose of CIS application controls is to establish specific control procedures over the accounting applications in order to provide reasonable assurance that all transactions are authorized and recorded, and are processed completely, accurately and on a timely basis. CIS application controls include:
 - (a) *Controls over input*—designed to provide reasonable assurance that:
 - Transactions are properly authorized before being processed by the computer.
 - Transactions are accurately converted into machine readable form and recorded in the computer data files.
 - Transactions are not lost, added, duplicated or improperly changed.
 - Incorrect transactions are rejected, corrected and, if necessary, resubmitted on a timely basis.
 - (b) *Controls over processing and computer data files*—designed to provide reasonable assurance that:
 - Transactions, including system generated transactions, are properly processed by the computer.
 - Transactions are not lost, added, duplicated or improperly changed.
 - Processing errors are identified and corrected on a timely basis.
 - (c) *Controls over output*—designed to provide reasonable assurance that:
 - Results of processing are accurate.
 - Access to output is restricted to authorized personnel.
 - Output is provided to appropriate authorized personnel on a timely basis.

Review of General CIS Controls

9. The general CIS controls which the auditor may wish to test are described in paragraph 6. The auditor should consider how these general CIS controls affect the CIS applications significant to the audit. General CIS controls that relate to some or all applications are typically interdependent controls in that their operation is often essential to the effectiveness of CIS application controls. Accordingly, it may be more efficient to review the design of the general controls before reviewing the application controls.

Review of CIS Application Controls

10. Control over input, processing, data files and output may be carried out by CIS personnel, by users of the system, by a separate control group, or may be

programmed into application software. CIS application controls which the auditor may wish to test include:

- (a) *Manual controls exercised by the user*—if manual controls exercised by the user of the application system are capable of providing reasonable assurance that the system’s output is complete, accurate and authorized, the auditor may decide to limit tests of control to these manual controls (e.g., the manual controls exercised by the user over a computerized payroll system for salaried employees could include an anticipatory input control total for gross pay, the test checking of net salary output computations, the approval of the payments and transfer of funds, comparison to payroll register amounts, and prompt bank reconciliation). In this case, the auditor may wish to test only the manual controls exercised by the user.
- (b) *Controls over system output*—if, in addition to manual controls exercised by the user, the controls to be tested use information produced by the computer or are contained within computer programs, it may be possible to test such controls by examining the system’s output using either manual or computer-assisted audit techniques. Such output may be in the form of magnetic media, microfilm or printouts (e.g., the auditor may test controls exercised by the entity over the reconciliation of report totals to the general ledger control accounts and may perform manual tests of those reconciliations). Alternatively, where the reconciliation is performed by computer, the auditor may wish to test the reconciliation by reperforming the control with the use of computer-assisted audit techniques (see International Auditing Practice Statement 1009 “Computer-Assisted Audit Techniques”).
- (c) *Programmed control procedures*—in the case of certain computer systems, the auditor may find that it is not possible or, in some cases, not practical to test controls by examining only user controls or the system’s output (e.g., in an application that does not provide printouts of critical approvals or overrides to normal policies, the auditor may want to test control procedures contained within the application program). The auditor may consider performing tests of control by using computer-assisted audit techniques, such as test data, reprocessing transaction data or, in unusual situations, examining the coding of the application program.

Evaluation

11. The general CIS controls may have a pervasive effect on the processing of transactions in application systems. If these controls are not effective, there may be a risk that misstatements might occur and go undetected in the application systems. Thus, weaknesses in general CIS controls may preclude testing certain CIS application controls; however, manual procedures exercised by users may provide effective control at the application level.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1009

COMPUTER-ASSISTED AUDIT TECHNIQUES

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The International Auditing Practices Committee (“IAPC”) of the International Federation of Accountants issues International Auditing Practices Statements (“Statements”) to provide practical assistance to auditors in implementing the International Standards on Auditing (“ISAs”) or to promote good practice. Statements do not have the authority of ISAs.

This Statement does not establish any new basic principles or essential procedures; its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of the ISAs regarding the use of Computer Assisted Audit Techniques as an audit tool. This Statement applies to all uses of CAATs involving a computer of any type or size. The auditor exercises professional judgment to determine the extent to which any of the audit procedures described in this Statement may be appropriate in the light of the requirements of the ISAs and the entity’s particular circumstances.

The IAPC approved this International Auditing Practice Statement in June 2001 for publication in July 2001.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where there is no PSP, the IAPS applies in all material respects to the public sector.

Introduction

1. The overall objectives and scope of an audit do not change when an audit is conducted in a computer information technology (IT) environment. The application of auditing procedures may, however, require the auditor to consider techniques known as Computer Assisted Audit Techniques (CAATs) that use the computer as an audit tool.
2. CAATs may improve the effectiveness and efficiency of auditing procedures. They may also provide effective tests of control and substantive procedures where there are no input documents or a visible audit trail, or where population and sample sizes are very large.
3. The purpose of this Statement is to provide guidance on the use of CAATs. It applies to all uses of CAATs involving a computer of any type or size. Special considerations relating to small entity IT environments are discussed in paragraph 26.

Description of Computer Assisted Audit Techniques (CAATs)

4. This Statement describes computer assisted audit techniques including computer tools, collectively referred to as CAATs. CAATs may be used in performing various auditing procedures, including the following:
 - Tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;
 - Analytical procedures, for example, identifying inconsistencies or significant fluctuations;
 - Tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management;
 - Sampling programs to extract data for audit testing;
 - Tests of application controls, for example, testing the functioning of a programmed control; and
 - Reperforming calculations performed by the entity's accounting systems.
5. CAATs are computer programs and data the auditor uses as part of the audit procedures to process data of audit significance contained in an entity's information systems. The data may be transaction data, on which the auditor wishes to perform tests of controls or substantive procedures, or they may be other types of data. For example, details of the application of some general controls may be kept in the form of text or other files by applications that are not part of the accounting system. The auditor can use CAATS to review those files to gain evidence of the existence and operation of those controls. CAATS

or system management programs. Regardless of the origin of the programs, the auditor substantiates their appropriateness and validity for audit purposes before using them.

- *Package programs* are generalized computer programs designed to perform data processing functions, such as reading data, selecting and analyzing information, performing calculations, creating data files and reporting in a format specified by the auditor.
- *Purpose-written programs* perform audit tasks in specific circumstances. These programs may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases the auditor may use an entity's existing programs in their original or modified state because it may be more efficient than developing independent programs.
- *Utility programs* are used by an entity to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic record counts or control totals.
- *System Management* programs are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs, these tools are not specifically designed for auditing use and their use requires additional care.
- *Embedded Audit Routines* are sometimes built into an entity's computer system to provide data for later use by the auditor. These include:
 - **Snapshots:** This technique involves taking a picture of a transaction as it flows through the computer systems. Audit software routines are embedded at different points in the processing logic to capture images of the transaction as it progresses through the various stages of the processing. Such a technique permits an auditor to track data and evaluate the computer processes applied to the data.
 - **System Control Audit Review File:** This involves embedding audit software modules within an application system to provide continuous monitoring of the system's transactions. The information is collected into a special computer file that the auditor can examine.
- *Test data techniques* are sometimes used during an audit by entering data (for example, a sample of transactions) into an entity's computer system, and comparing the results obtained with predetermined results. An auditor might use test data to:
 - Test specific controls in computer programs, such as on-line password and data access controls;
 - Test transactions selected from previously processed transactions or created by the auditor to test specific processing characteristics of an

entity's information systems. Such transactions are generally processed separately from the entity's normal processing; and

- Test transactions used in an integrated test facility where a "dummy" unit (for example, a fictitious department or employee) is established, and to which test transactions are posted during the normal processing cycle.

When test data are processed with the entity's normal processing, the auditor ensures that the test transactions are subsequently eliminated from the entity's accounting records.

6. The increasing power and sophistication of PCs, particularly laptops, has resulted in other tools for the auditor to use. In some cases, the laptops will be linked to the auditor's main computer systems. Examples of such techniques include:
 - Expert systems, for example in the design of audit programs and in audit planning and risk assessment;
 - Tools to evaluate a client's risk management procedures;
 - Electronic working papers, which provide for the direct extraction of data from the client's computer records, for example, by downloading the general ledger for audit testing; and
 - Corporate and financial modeling programs for use as predictive audit tests.

These techniques are more commonly referred to as "audit automation."

Considerations in the Use of CAATs

7. When planning an audit, the auditor may consider an appropriate combination of manual and computer assisted audit techniques. In determining whether to use CAATs, the factors to consider include:
 - The IT knowledge, expertise and experience of the audit team;
 - The availability of CAATs and suitable computer facilities and data;
 - The impracticability of manual tests;
 - Effectiveness and efficiency; and
 - Timing.

Before using CAATS the auditor considers the controls incorporated in the design of the entity's computer systems to which the CAATS would be applied in order to determine whether, and if so, how, CAATs should be employed.

IT Knowledge, Expertise, and Experience of the Audit Team

8. ISA 401 “Auditing in a Computer Information Systems Environment” deals with the level of skill and competence the audit team needs to conduct an audit in an IT environment. It provides guidance when an auditor delegates work to assistants with IT skills or when the auditor uses work performed by other auditors or experts with such skills. Specifically, the audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted. The level of knowledge required depends on the complexity and nature of the CAAT and of the entity’s information system.

Availability of CAATs and Suitable Computer Facilities

9. The auditor considers the availability of CAATs, suitable computer facilities (controlled as described in paragraphs 18-23) and the necessary computer-based information systems and data. The auditor may plan to use other computer facilities when the use of CAATs on an entity’s computer is uneconomical or impractical, for example, because of an incompatibility between the auditor’s package program and the entity’s computer. Additionally, the auditor may elect to use their own facilities, such as PCs or laptops.
10. The cooperation of the entity’s personnel may be required to provide processing facilities at a convenient time, to assist with activities such as loading and running of the CAATs on the entity’s system, and to provide copies of data files in the format required by the auditor.

Impracticability of Manual Tests

11. Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure. In addition, many computer information systems perform tasks for which no hard copy evidence is available and, therefore, it may be impracticable for the auditor to perform tests manually. The lack of hard copy evidence may occur at different stages in the business cycle.
 - Source information may be initiated electronically, such as by voice activation, electronic data imaging, or point of sale electronic funds transfer. In addition, some transactions, such as discounts and interest calculations, may be generated directly by computer programs with no specific authorization of individual transactions.
 - A system may not produce a visible audit trail providing assurance as to the completeness and accuracy of transactions processed. For example, a computer program might match delivery notes and suppliers’ invoices. In addition, programmed control procedures, such as checking customer credit limits, may provide hard copy evidence only on an exception basis.

- A system may not produce hard copy reports. In addition, a printed report may contain only summary totals while computer files retain the supporting details.

Effectiveness and Efficiency

12. The effectiveness and efficiency of auditing procedures may be improved by using CAATs to obtain and evaluate audit evidence. CAATs are often an efficient means of testing a large number of transactions or controls over large populations by:
 - Analyzing and selecting samples from a large volume of transactions;
 - Applying analytical procedures; and
 - Performing substantive procedures.
13. Matters relating to efficiency that an auditor might consider include:
 - The time taken to plan, design, execute and evaluate a CAAT;
 - Technical review and assistance hours;
 - Designing and printing of forms (for example, confirmations); and
 - Availability of computer resources.
14. In evaluating the effectiveness and efficiency of a CAAT, the auditor considers the continuing use of the CAAT application. The initial planning, design and development of a CAAT will usually benefit audits in subsequent periods.

Timing

15. Certain data, such as transaction details, are often kept for only a short time, and may not be available in machine-readable form by the time the auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.
16. Where the time available to perform an audit is limited, the auditor may plan to use a CAAT because its use will meet the auditor's time requirement better than other possible procedures.

Using CAATs

17. The major steps to be undertaken by the auditor in the application of a CAAT are to:
 - (a) Set the objective of the CAAT application;
 - (b) Determine the content and accessibility of the entity's files;
 - (c) Identify the specific files or databases to be examined;

- (d) Understand the relationship between the data tables where a database is to be examined;
- (e) Define the specific tests or procedures and related transactions and balances affected;
- (f) Define the output requirements;
- (g) Arrange with the user and IT departments, if appropriate, for copies of the relevant files or database tables to be made at the appropriate cut off date and time;
- (h) Identify the personnel who may participate in the design and application of the CAAT;
- (i) Refine the estimates of costs and benefits;
- (j) Ensure that the use of the CAAT is properly controlled and documented;
- (k) Arrange the administrative activities, including the necessary skills and computer facilities;
- (l) Reconcile data to be used for the CAAT with the accounting records;
- (m) Execute the CAAT application; and
- (n) Evaluate the results.

Controlling the CAAT Application

18. The specific procedures necessary to control the use of a CAAT depend on the particular application. In establishing control, the auditor considers the need to:
 - (a) Approve specifications and conduct a review of the work to be performed by the CAAT;
 - (b) Review the entity's general controls that may contribute to the integrity of the CAAT, for example, controls over program changes and access to computer files. When such controls cannot be relied on to ensure the integrity of the CAAT, the auditor may consider processing the CAAT application at another suitable computer facility; and
 - (c) Ensure appropriate integration of the output by the auditor into the audit process.
19. Procedures carried out by the auditor to control CAAT applications may include:
 - (a) Participating in the design and testing of the CAAT;
 - (b) Checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications;

- (c) Asking the entity's computer staff to review the operating system instructions to ensure that the software will run in the entity's computer installation;
- (d) Running the audit software on small test files before running it on the main data files;
- (e) Checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete;
- (f) Obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information; and
- (g) Establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

When the auditor intends to perform audit procedures concurrently with on-line processing, the auditor reviews those procedures with appropriate client personnel and obtains approval before conducting the tests to help avoid the inadvertent corruption of client records.

20. To ensure appropriate control procedures, the presence of the auditor is not necessarily required at the computer facility during the running of a CAAT. It may, however, provide practical advantages, such as being able to control distribution of the output and ensuring the timely correction of errors, for example, if the wrong input file were to be used.
21. Audit procedures to control test data applications may include:
 - Controlling the sequence of submissions of test data where it spans several processing cycles;
 - Performing test runs containing small amounts of test data before submitting the main audit test data;
 - Predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total;
 - Confirming that the current version of the programs was used to process the test data; and
 - Testing whether the programs used to process the test data were the programs the entity used throughout the applicable audit period.
22. When using a CAAT, the auditor may require the cooperation of entity staff with extensive knowledge of the computer installation. In such circumstances, the auditor considers whether the staff improperly influenced the results of the CAAT.

23. Audit procedures to control the use of audit-enabling software may include:
- Verifying the completeness, accuracy and availability of the relevant data, for example, historical data may be required to build a financial model;
 - Reviewing the reasonableness of assumptions used in the application of the tool set, particularly when using modeling software;
 - Verifying availability of resources skilled in the use and control of the selected tools; and
 - Confirming the appropriateness of the tool set to the audit objective, for example, the use of industry specific systems may be necessary for the design of audit programs for unique business cycles.

Documentation

24. The standard of working paper documentation and retention procedures for a CAAT is consistent with that for the audit as a whole (see ISA 230 “Documentation”).
25. The working papers need to contain sufficient documentation to describe the CAAT application, such as:

(a) Planning

- CAAT objectives;
- Consideration of the specific CAAT to be used;
- Controls to be exercised; and
- Staffing, timing and cost.

(b) Execution

- CAAT preparation and testing procedures and controls;
- Details of the tests performed by the CAAT;
- Details of input, processing and output; and
- Relevant technical information about the entity’s accounting system, such as file layouts.

(c) Audit Evidence

- Output provided;
- Description of the audit work performed on the output; and
- Audit conclusions.

(d) Other

- Recommendations to entity management.

In addition, it may be useful to document suggestions for using the CAAT in future years.

Using CAATs in Small Entity IT Environments

26. Although the general principles outlined in this Statement apply in small entity IT environments, the following points need special consideration:
 - (a) The level of general controls may be such that the auditor will place less reliance on the system of internal control. This will result in greater emphasis on tests of details of transactions and balances and analytical review procedures, which may increase the effectiveness of certain CAATs, particularly audit software.
 - (b) Where smaller volumes of data are processed, manual methods may be more cost effective.
 - (c) A small entity may not be able to provide adequate technical assistance to the auditor, making the use of CAATs impracticable.
 - (d) Certain audit package programs may not operate on small computers, thus restricting the auditor's choice of CAATs. The entity's data files may, however, be copied and processed on another suitable computer.

**INTERNATIONAL AUDITING
PRACTICE STATEMENT 1010**

**THE CONSIDERATION OF ENVIRONMENTAL MATTERS IN
THE AUDIT OF FINANCIAL STATEMENTS**

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International Auditing Practices Statements (“Statements”) are issued by the International Auditing Practices Committee (“IAPC”) of the International Federation of Accountants to provide practical assistance to auditors in implementing the International Standards on Auditing (“ISAs”) or to promote good practice. Statements do not have the authority of ISAs.

This Statement does not establish any new basic principles or essential procedures: its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of the ISAs in cases when environmental matters are significant to the financial statements of the entity. The extent to which any of the audit procedures described in this Statement may be appropriate in a particular case requires the exercise of the auditor’s judgment in the light of the requirements of the ISAs and the circumstances of the entity.

This Statement was approved by the IAPC in March 1998 for publication in March 1998.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where no PSP is added, the IAPS is applicable in all material respects to the public sector.

Introduction

The Purpose of this Statement

1. Environmental matters are becoming significant to an increasing number of entities and may, in certain circumstances, have a material impact on their financial statements. These issues are of growing interest to the users of financial statements. The recognition, measurement, and disclosure of these matters is the responsibility of management.
2. For some entities, environmental matters are not significant. However, when environmental matters are significant to an entity, there may be a risk of material misstatement (including inadequate disclosure) in the financial statements arising from such matters: in these circumstances, the auditor needs to give consideration to environmental matters in the audit of the financial statements.
3. Environmental matters can be complex and may therefore require additional consideration by auditors. This Statement provides practical assistance to auditors by describing:
 - (a) The auditor's main considerations in an audit of financial statements with respect to environmental matters;
 - (b) Examples of possible impacts of environmental matters on financial statements; and
 - (c) Guidance that the auditor may consider when exercising professional judgment in this context to determine the nature, timing, and extent of audit procedures with respect to:
 - Knowledge of the business (ISA 310);
 - Risk assessments and internal control (ISA 400);
 - Consideration of laws and regulations (ISA 250); and
 - Other substantive procedures (ISA 620 and some others).

The guidance under (c) reflects the typical sequence of the audit process. Having acquired a sufficient knowledge of the business the auditor assesses the risk of a material misstatement in the financial statements. This assessment includes consideration of environmental laws and regulations that may pertain to the entity, and provides a basis for the auditor to decide whether there is a need to pay attention to environmental matters in the course of the audit of financial statements.

Appendix 1 provides illustrative questions that an auditor may consider when obtaining a knowledge of the business, including an understanding of the entity's control environment and control procedures from an environmental point of view. Appendix 2 provides examples of substantive procedures that an auditor may perform to detect a material misstatement in the financial

statements due to environmental matters. These appendices are included for illustrative purposes only. It is not intended that all, or even any, of the questions or examples will necessarily be appropriate in any particular case.

4. This Statement does not establish any new basic principles or essential procedures: its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of the ISAs in cases when environmental matters are significant to the financial statements of the entity. The extent to which any of the audit procedures described in this Statement may be appropriate in a particular case requires the exercise of the auditor's judgment in the light of the requirements of the ISAs and the circumstances of the entity.
5. The Statement does not provide guidance on the audit of the financial statements of insurance companies with regard to claims incurred under insurance policies relating to environmental matters affecting policyholders.

The Auditor's Main Considerations with respect to Environmental Matters

6. The objective of an audit of financial statements is:
“...to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.” (ISA 200, paragraph 2).
7. The auditor's opinion relates to the financial statements taken as a whole and not to any specific aspect. When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. However, an audit can not be expected to detect noncompliance with all laws and regulations (ISA 250, paragraph 2). In particular, with respect to the entity's compliance with environmental laws and regulations, the auditor's purpose is not to plan the audit to detect possible breaches of environmental laws and regulations; nor are the auditor's procedures sufficient to draw a conclusion on the entity's compliance with environmental laws and regulations or the adequacy of its controls over environmental matters.
8. In all audits, when developing the overall audit plan, the auditor assesses inherent risk at the financial statement level (ISA 400, paragraph 11). The auditor uses professional judgment to evaluate the factors relevant to this assessment. In certain circumstances these factors may include the risk of material misstatement of the financial statements due to environmental matters. The need to consider, and extent of the consideration of, environmental matters in an audit of financial statements depends on the auditor's judgment as to whether environmental matters give rise to a risk of material misstatement in the financial statements. In some cases, no specific audit procedures may be judged necessary. In other cases, however, the auditor uses professional judgment to determine the nature, timing and extent of the

specific procedures considered necessary in order to obtain sufficient appropriate audit evidence that the financial statements are not materially misstated. If the auditor does not have the professional competence to perform these procedures, technical advice may be sought from specialists, such as lawyers, engineers, or other environmental experts.

9. To conclude that an entity operates in compliance with existing environmental laws or regulations ordinarily requires the technical skills of environmental experts, which the auditor cannot be expected to possess. Also, whether a particular event or condition that comes to the attention of the auditor is a breach of environmental laws and regulations is a legal determination that is ordinarily beyond the auditor's professional competence. However, as with other laws and regulations:

“...the auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute noncompliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute noncompliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.” (ISA 250, paragraph 4.)

Environmental Matters and their Impact on the Financial Statements

10. For the purpose of this Statement, “environmental matters” are defined as:
 - (a) Initiatives to prevent, abate, or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources (such initiatives may be required by environmental laws and regulations or by contract, or they may be undertaken voluntarily);
 - (b) Consequences of violating environmental laws and regulations;
 - (c) Consequences of environmental damage done to others or to natural resources; and
 - (d) Consequences of vicarious liability imposed by law (for example, liability for damages caused by previous owners).
11. Some examples of environmental matters affecting the financial statements are the following:
 - The introduction of environmental laws and regulations may involve an impairment of assets and consequently a need to write down their carrying value;
 - Failure to comply with legal requirements concerning environmental matters, such as emissions or waste disposal, or changes to legislation with retrospective effect, may require accrual of remediation, compensation or legal costs;

- Some entities, for example in the extraction industries (oil and gas exploration or mining), chemical manufacturers or waste management companies may incur environmental obligation as a direct by-product of their core businesses;
 - Constructive obligations that stem from a voluntary initiative, for example an entity may have identified contamination of land and, although under no legal obligation, it may have decided to remedy the contamination, because of its concern for its long-term reputation and its relationship with the community;¹
 - An entity may need to disclose in the notes the existence of a contingent liability where the expense relating to environmental matters cannot be reasonably estimated; and
 - In extreme situations, noncompliance with certain environmental laws and regulations may affect the continuance of an entity as a going concern and consequently may affect the disclosures and the basis of preparation of the financial statements.
12. As of the date of publication of this Statement there are few authoritative accounting standards, whether International Accounting Standards or national standards, that explicitly address the recognition, measurement, and disclosure of the consequences for the financial statements arising from environmental matters. However, existing accounting standards generally do provide appropriate general considerations that also apply to the recognition, measurement and disclosure of environmental matters in financial statements.²

Guidance on the Application of ISA 310 Knowledge of the Business

13. In all audits a sufficient knowledge of the client's business is needed to enable the auditor to identify and understand matters that may have a significant effect on the financial statements, the audit process and the audit report (ISA 310, paragraph 2). In obtaining a sufficient knowledge of the business, the auditor considers important conditions affecting the entity's business and the industry in which it operates, such as environmental requirements and problems.

¹ The term "constructive obligations" (as opposed to "present legal obligations") has been clarified by the International Accounting Standards Committee as follows: "Sometimes the actions or representations of the enterprise's management, or changes in the economic environment, directly influence the reasonable expectations or actions of those outside the enterprise and, although they have no legal entitlement, they have other sanctions that leave the enterprise with no realistic alternative to certain expenditures. Such obligations are sometimes called "constructive obligations" (IASC: ED 59 Proposed International Accounting Standard on "Provisions, Contingent Liabilities and Contingent Assets", paragraph 16).

² For example, International Accounting Standard No. 10, on "Contingencies and Events Occurring After the Balance Sheet Date", provides the general considerations which apply to the recognition and disclosure of contingent losses, including losses as a consequence of environmental matters. IAS 10 is currently under review by IASC: ED 59 Proposed International Accounting Standard, on "Provisions, Contingent Liabilities and Contingent Assets", contains some examples of environmental liabilities.

14. The auditor's level of knowledge with regard to environmental matters, appropriate for a particular engagement is less than that ordinarily possessed by management or by environmental experts. However, the auditor's level of knowledge needs to be sufficient to enable the auditor to identify and obtain an understanding of the events, transactions, and practices related to environmental matters that may have a material effect on the financial statements and on the audit.
15. The auditor considers the industry in which the entity operates, as it may be indicative of the possible existence of environmental liabilities and contingencies. Certain industries, by their nature, tend to be exposed to significant environmental risk.³ These include the chemical, oil and gas, pharmaceutical, metallurgical, mining, and utility industries.
16. An entity does not, however, need to operate in one of these industries to be exposed to significant environmental risk. Potential exposure to significant environmental risk may in general arise for any entity that:
 - (a) Is subject to environmental laws and regulations to a substantial degree;
 - (b) Owns, or holds security over, sites contaminated by previous owners ("vicarious liability"); or
 - (c) Has business processes that:
 - May cause contamination of soil and groundwater, contamination of surface water, or air pollution;
 - Use hazardous substances;
 - Generate or process hazardous waste; or
 - May have an adverse impact on customers, employees, or people that live in the neighborhood of the company's sites.

Guidance on the Application of ISA 400 Risk Assessments and Internal Control

17. This section of the Statement provides additional guidance on the application of certain aspects of ISA 400 by explaining the relationship between environmental matters and the audit risk model. More specifically, it provides examples of the auditor's possible consideration of environmental matters with respect to the:
 - Inherent risk assessment;
 - Accounting and internal control systems;
 - Control environment; and
 - Control procedures.

³ "Environmental risk" is defined in paragraph 18 of this Statement as a possible component of inherent risk.

Inherent Risk

18. The auditor uses professional judgment to evaluate the factors relevant to the assessment of inherent risk for the development of the overall audit plan. In certain circumstances these factors may include the risk of material misstatement of the financial statements due to environmental matters (“environmental risk”). Thus, environmental risk may be a component of inherent risk.
19. Examples of environmental risk at financial statement level are:
 - The risk of compliance costs arising from legislation or from contractual requirements;
 - The risk of noncompliance with environmental laws and regulations; and
 - The possible effects of specific environmental requirements of customers and their possible reactions to the entity’s environmental conduct.
20. If the auditor considers that environmental risk is a significant component in the inherent risk assessment, the auditor relates this assessment to material account balances and classes of transactions at the assertion level when developing the audit program (ISA 400, paragraph 11).
21. Examples of environmental risk at the level of account balances or classes of transactions are:
 - The extent to which an account balance is based on complex accounting estimates with respect to environmental matters (for example, the measurement of an environmental provision for the removal of contaminated land and future site restoration). ISA 540 “Audit of Accounting Estimates” provides guidance to the auditor for these situations. Inherent risk may be high if there is a lack of data upon which to base a reasonable estimate, for example because of complex technologies for removal and site restoration; and
 - The extent to which an account balance is affected by unusual or non-routine transactions involving environmental matters.

Accounting and Internal Control Systems

22. It is management’s responsibility to design and operate internal controls to assist in achieving, as far as practicable, the orderly and efficient conduct of the business, including any environmental aspects. The way in which management achieves control over environmental matters differs in practice:
 - entities with low exposure to environmental risk, or smaller entities, will probably monitor and control their environmental matters as part of their normal accounting and internal control systems;
 - some entities that operate in industries with a high exposure to environmental risk may design and operate a separate internal control

sub-system for this purpose, that conforms with existing standards for Environmental Management Systems (EMS);⁴ and

- other entities design and operate all of their controls in an integrated control system, encompassing policies and procedures related to accounting, environmental and other matters (for example, quality, health and safety).
23. For the auditor's purposes it makes no difference how management actually achieves control over environmental matters. In particular, the lack of an EMS does not in itself mean that the auditor has to conclude that there is inadequate control over the environmental aspects of the business.
24. Only if, in the auditor's judgment, environmental matters may have a material effect on the financial statements of an entity, does the auditor need to obtain an understanding of the entity's significant policies and procedures with respect to its monitoring of, and control over these environmental matters (the entity's "environmental controls"), in order to plan the audit and develop an effective audit approach. In such cases the auditor is only concerned with those environmental controls (within or outside the accounting and internal control systems) that are considered relevant to the audit of the financial statements.

Control Environment

25. In all audits, the auditor obtains an understanding of the control environment sufficient to assess directors' and management's attitudes, awareness, and actions regarding internal controls and their importance in the entity (ISA 400, paragraph 19). Similar conditions as described in paragraph 24 of this Statement apply to the auditor's need to obtain an understanding of the control environment. Factors in obtaining an understanding of the control environment with respect to environmental matters may include:
- The functioning of the board of directors and its committees, with respect to the entity's environmental controls;
 - Management's philosophy and operating style and its approach to environmental issues, such as any efforts to improve the environmental performance of the entity, participation in certification programs for the entity's EMS, and the voluntary publication of environmental

⁴ Standards for an EMS have been issued by the International Organization for Standardization (ISO 14001: "Environmental management systems—Specification with guidance for use" International Organization for Standardization, Geneva, Switzerland, First edition 1996–09–01). The specification requires participating organizations to develop and implement a systematic approach to managing significant environmental aspects. It also includes a commitment to continual improvement. When in certain countries or regions other standards for an EMS are in use, such as the standards issued by the European Commission on behalf of an entity's participation in the Eco-Management and Audit Scheme (EMAS), those national or regional standards can be used by the entity as benchmarks also.

performance reports.⁵ This also encompasses management's reaction to external influences such as those relating to monitoring and compliance requirements imposed by regulatory bodies and enforcement agencies;

- The entity's organizational structure and methods of assigning authority and responsibility to deal with environmental operating functions and regulatory requirements; and
- Management's control system, including the internal auditing function, the performance of "environmental audits" (see paragraph 45 of this Statement), personnel policies, and procedures and appropriate segregation of duties.

Control Procedures

26. Applying the considerations and conditions mentioned in paragraphs 18–20 the auditor may come to the conclusion that there is a need to obtain an understanding of environmental controls. Examples of environmental controls are policies and procedures:
 - To monitor compliance with the entity's environmental policy, as well as with relevant environmental laws and regulations;
 - To maintain an appropriate environmental information system, which may include recording of, for example, physical quantities of emissions and hazardous waste, environmental characteristics of products, complaints from stakeholders, results of inspections performed by enforcement agencies, occurrence and effects of incidents, etc;
 - To provide for the reconciliation of environmental information with relevant financial data, for example, physical quantities of waste production in relation to cost of waste disposal; and
 - To identify potential environmental matters and related contingencies affecting the entity.
27. If the entity has established environmental controls, the auditor also inquires of those persons overseeing such controls as to whether any environmental matters have been identified that may have a material effect on the financial statements.
28. One of the possibilities for the auditor to obtain an understanding of the entity's control over environmental matters may be to read the entity's environmental performance report, if available. That report often discloses the entity's environmental commitments and policies, and its major environmental controls.

⁵ An "environmental performance report" is a report, separate from the financial statements, in which an entity provides third parties with qualitative information on the entity's commitments towards the environmental aspects of the business, its policies and targets in that field, its achievement in managing the relationship between its business processes and environmental risk, and quantitative information on its environmental performance.

Control Risk

29. After obtaining an understanding of the accounting and internal control systems, the auditor may need to consider the effect of environmental matters in the assessment of control risk and in any tests of control that may be necessary to support that assessment. (The auditor's assessment of control risk is described in paragraphs 21–39 of ISA 400.)

Guidance on the Application of ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements

30. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management (ISA 250, paragraph 9). In this context, management has to take into account:
- Laws and regulations that impose liability for remediation of environmental pollution arising from past events; this liability may not be limited to the entity's own actions but may also be imposed on the current owner of a property where the damage was incurred by a previous owner ("vicarious liability");
 - Pollution control and pollution prevention laws that are directed at identifying or regulating sources of pollution, or reducing emissions or discharges of pollutants;
 - Environmental licenses that, in certain jurisdictions, specify the entity's operating conditions from an environmental point of view, for example, a specification of the maximum levels of emissions; and
 - The requirements of regulatory authorities with respect to environmental matters.
31. Changes in environmental legislation could have significant consequences for the operations of the entity and may even result in liabilities that relate to past events which, at the time, were not governed by legislation. An example of the first category is a change in noise regulations that could curtail future use of plant or machinery. An example of the latter is an increase in standards that could render a waste generator liable for waste disposed of in previous years, even though disposal of the waste was in compliance with the then existing practice.
32. The auditor is not, and cannot be held responsible for preventing noncompliance with environmental laws and regulations. Also, as stated in paragraph 9, the detection of possible breaches of environmental laws and regulations is ordinarily beyond the auditor's professional competence. However, an audit carried out in accordance with ISAs is planned and performed with an attitude of professional skepticism, recognizing that the audit may reveal conditions or events that would lead to questioning whether the entity is complying with relevant environmental laws and regulations in so

far as noncompliance could result in a material misstatement of the financial statements.

33. As part of the planning process of the audit, the auditor obtains a general understanding of such environmental laws and regulations which, if violated, could reasonably be expected to result in a material misstatement in the financial statements, and of the policies and procedures used by the entity to comply with those laws and regulations. In obtaining this general understanding, the auditor recognizes that noncompliance with some environmental laws and regulations may severely impact the operations of the entity.
34. To obtain a general understanding of relevant environmental laws and regulations, the auditor ordinarily:
 - Uses existing knowledge of the entity's industry and business;
 - Inquires of management (including key officers for environmental matters) concerning the entity's policies and procedures regarding compliance with relevant environmental laws and regulations;
 - Inquires of management as to the environmental laws and regulations that may be expected to have a fundamental effect on the operations of the entity. Noncompliance with these requirements might cause the entity to cease operations, or call into question the entity's continuance as a going concern; and
 - Discusses with management the policies or procedures adopted for identifying, evaluating and accounting for litigation, claims and assessments.

Substantive Procedures

35. This section of the Statement provides guidance on substantive procedures, including the application of ISA 620 "Using the Work of an Expert".
36. The auditor considers the assessed levels of inherent and control risk in determining the nature, timing and extent of substantive procedures required to reduce the risk of not detecting a material misstatement in the financial statements to an acceptable level, including any material misstatements if the entity fails to properly recognize, measure or disclose the effects of environmental matters.
37. Substantive procedures include obtaining evidence through inquiry of both management responsible for the preparation of the financial statements and key officers responsible for environmental matters. The auditor considers the need to gather corroborative audit evidence for any environmental assertions from sources inside or outside the entity. In certain situations, the auditor may need to consider using the work of environmental experts.

38. Examples of substantive procedures that an auditor may perform to detect a material misstatement in the financial statements due to environmental matters, are provided in Appendix 2.
39. Most of the audit evidence available to the auditor is persuasive rather than conclusive. Therefore, the auditor needs to use professional judgment in determining whether the planned substantive procedures, either individually or in combination, are appropriate. The use of professional judgment may become even more important because of a number of difficulties with respect to the recognition and measurement of the consequences of environmental matters in the financial statements, for example:
- Often there is a considerable time delay between the activity that basically causes an environmental issue, and the identification of it by the entity or regulators;
 - Accounting estimates may not have an established historical pattern or may have wide ranges of reasonableness because of the number and nature of assumptions underlying the determination of these estimates;
 - Environmental laws or regulations are evolving, and interpretation may be difficult or ambiguous. Consultation of an expert may be necessary to assess the impact of these laws and regulations on the valuation of certain assets (for example, assets that contain asbestos). Making a reasonable estimate of liabilities for known obligations may also appear to be difficult in practice; or
 - Liabilities may arise other than as a result of legal or contractual obligations.
40. In the course of the audit process, for example in gathering knowledge of the business, in the assessments of inherent and control risk, or in performing certain substantive procedures, evidence may come to the attention of the auditor that indicates the existence of a risk that the financial statements may be materially misstated due to environmental matters. Examples of such circumstances include:
- The existence of reports outlining material environmental problems prepared by environmental experts, internal auditors or environmental auditors;
 - Violations of environmental laws and regulations cited in correspondence with, or in reports issued by regulatory agencies;
 - Inclusion of the entity's name in a publicly available register, or plan, for the restoration of soil contamination (if one exists);
 - Media comment about the entity related to major environmental matters;
 - Comments relating to environmental matters made in lawyers' letters;

- Evidence indicating purchases of goods and services relating to environmental matters that are unusual in relation to the nature of the entity's business; and
- Increased or unusual legal or environmental consultants' fees, or payments of penalties as a result of violation of environmental laws and regulations.

In these circumstances the auditor considers the need to re-assess inherent and control risk and the resulting impact on detection risk. If necessary, the auditor may decide to consult an environmental expert.

Environmental Experts

41. Management is responsible for accounting estimates included in the financial statements. Management may require technical advice from specialists such as lawyers, engineers or other environmental experts to assist in developing accounting estimates and disclosures related to environmental matters. Such experts may be involved in many stages in the process of developing accounting estimates and disclosures, including assisting management in:
 - Identifying situations where the recognition of liabilities and related estimates is required (for example, an environmental engineer may make a preliminary investigation of a site to determine if contamination has occurred, or a lawyer may be used to determine the entity's legal responsibility to restore the site);
 - Gathering the necessary data on which to base estimates and providing details of information that needs to be disclosed in the financial statements (for example, an environmental expert may test a site in order to assist in quantifying the nature and extent of contamination and considering acceptable alternative methods of site restoration); and
 - Designing the appropriate remedial action plan and calculating related financial consequences.
42. If the auditor intends to use the results of such work as part of the audit, the auditor considers the adequacy of the work performed by environmental experts for the purposes of the audit, as well as the expert's competence and objectivity, in accordance with ISA 620 "Using the Work of an Expert". The auditor may need to engage another expert in considering such work, to apply additional procedures, or to modify the auditor's report.
43. As the environmental area is an emerging specialty, the expert's professional competence may be more difficult to assess than is the case with some other experts, because there may be no certification or licensing by, or membership of, an appropriate professional body. In this situation, it may be necessary for the auditor to give particular consideration to the experience and reputation of the environmental expert.

44. Timely and ongoing communication with the expert may assist the auditor to understand the nature, scope, objective and limitations of the expert's report. The report might deal with only one aspect of the entity's operations. For example, the expert's report may be based on cost estimates related to only one element of a particular issue (for example, soil contamination), rather than on cost estimates of all relevant issues (for example, contamination of soil and groundwater, including vicarious liability imposed by law). It is also necessary for the auditor to discuss the assumptions, methods, procedures, and source data used by the expert.

Environmental Audit

45. "Environmental audits" are becoming increasingly common in certain industries.⁶ The term "environmental audit" has a wide variety of meanings. They can be performed by external or internal experts (sometimes including internal auditors), at the discretion of the entity's management. In practice, persons from various disciplines can qualify to perform "environmental audits". Often the work is performed by a multi-disciplinary team. Normally, "environmental audits" are performed at the request of management and are for internal use. They may address various subject matters, including site contamination, or compliance with environmental laws and regulations. However, an "environmental audit" is not necessarily an equivalent to an audit of an environmental performance report.
46. The auditor of the entity's financial statements may consider using the findings of "environmental audits" as appropriate audit evidence. In that situation the auditor has to decide whether the "environmental audit" meets the evaluation criteria included in ISA 610 "Considering the Work of Internal Auditing" or ISA 620 "Using the Work of an Expert". Important criteria to be considered are:
- (a) The impact of the results of the environmental audit on the financial statements;
 - (b) The competency and skill of the environmental audit team and the objectivity of the auditors, specially when chosen from the entity's staff;
 - (c) The scope of the environmental audit, including management's reactions to the recommendations that result from the environmental audit and how this is evidenced;
 - (d) The due professional care exercised by the team in the performance of the environmental audit; and
 - (e) The proper direction, supervision, and review of the audit.

⁶ Guidelines for "environmental auditing" have been issued by the International Organization for Standardization (ISO), "Guidelines for environmental auditing—General principles" (International Organization for Standardization, Geneva, Switzerland, First Edition 1996-10-01).

Internal Audit

47. If the entity has an internal auditing function, the auditor considers whether the internal auditors address environmental aspects of the entity's operations as part of their internal auditing activities. If this is the case, the auditor considers the appropriateness of using such work for the purpose of the audit, applying the criteria set out in ISA 610 "Considering the Work of Internal Auditing".

Management Representations

48. ISA 580 "Management Representations" requires that the auditor obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. Much of the evidence available to the auditor with respect to the impact of environmental matters on the financial statements will be persuasive in nature rather than conclusive. The auditor may therefore wish to obtain specific representation that management:
- (a) Is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts;
 - (b) Is not aware of any other environmental matters that may have a material impact on the financial statements; or
 - (c) If aware of such matters, has disclosed them properly in the financial statements.

Reporting

49. When forming an opinion on the financial statements, the auditor considers whether the effects of environmental matters are adequately treated or disclosed in accordance with the appropriate financial reporting framework. In addition, the auditor reads any other information to be included with the financial statements in order to identify any material inconsistencies, for example, regarding environmental matters.
50. Management's assessment of uncertainties and the extent of their disclosure in the financial statements are key issues in determining the impact on the auditor's report. The auditor may conclude that there are significant uncertainties, or inappropriate disclosures, due to environmental matters. There may even be circumstances when, in the auditor's judgment, the going concern assumption is no longer appropriate. ISA 700 "The Auditor's Report on Financial Statements" and ISA 570 "Going Concern" provide detailed guidance to auditors in these circumstances.

Public Sector Perspective

1. *As stated in paragraph 3, this Statement provides practical assistance to auditors in identifying and addressing environmental matters in the context of an audit of financial statements. This guidance would generally be equally applicable to public sector auditors in their audit of the financial statements of governments and other public sector entities. However, it should be noted that the nature and scope of public sector audit engagements may be affected by legislation, regulation, ordinances and ministerial directives that impose additional audit and/or reporting responsibilities with respect to environmental issues.*
2. *As in the private sector, auditors of financial statements of governments and other public sector entities may need to consider the recognition, measurement and disclosure of any liabilities or contingencies for environmental damage. Liabilities or contingencies may arise through damage caused by the reporting entity or one of its agencies. However, in the public sector, liability or contingencies may also arise when the government accepts responsibility for clean-up or other costs associated with damage caused by others, if, for example, responsibility is unresolved or cannot be attributed to others.*
3. *Public sector auditors may, in some countries, be obliged to report instances of non compliance with environmental regulations found in the course of a financial statement audit, regardless of whether or not those instances of non-compliance have a material impact on the entity's financial statements.*
4. *A government's responsibilities may also include the monitoring of compliance with laws and regulations in relation to environmental matters. More specifically, this monitoring role will be the responsibility of a particular public sector agency or agencies. In performing the financial statement audit of such an agency or agencies the auditor may need to consider, for example, controls covering the imposing of appropriate charges/fines and the collection of fines. For unresolved cases consideration may also need to be given to the recognition, measurement and disclosure of any liabilities or contingencies.*

Appendix 1

Obtaining Knowledge of the Business from an Environmental Point of View— Illustrative Questions

The purpose of this appendix is to provide examples of questions that an auditor may consider when obtaining a knowledge of the business, including an understanding of the entity's control environment and control procedures, from an environmental point of view.

These examples are included for illustrative purposes only. It is not intended that all of the questions illustrated will be appropriate in any particular case. The questions need to be tailored to fit the particular circumstances of each engagement. In some cases, the auditor may judge it unnecessary to address any of these questions.

It may be necessary for the auditor to consult an environmental expert when evaluating the answers received from the entity's officers in response to any inquiries with regard to environmental matters.

Knowledge of the business

1. Does the entity operate in an industry that is exposed to significant environmental risk that may adversely affect the financial statements of the entity?
2. What are the environmental issues in the entity's industry in general?
3. Which environmental laws and regulations are applicable to the entity?
4. Are there any substances used in the entity's products or production processes that are part of a phase-out scheme required by legislation, or adopted voluntarily by the industry in which the client operates?
5. Do enforcement agencies monitor the entity's compliance with the requirements of environmental laws, regulations or licenses?
6. Have any regulatory actions been taken or reports been issued by enforcement agencies that may have a material impact on the entity and its financial statements?
7. Have initiatives been scheduled to prevent, abate or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources?
8. Is there a history of penalties and legal proceedings against the entity or its directors in connection with environmental matters? If so, what were the reasons for such actions?
9. Are any legal proceedings pending with regard to compliance with environmental laws and regulations?

10. Are environmental risks covered by insurance?

Control environment and control procedures

11. What is management's philosophy and operating style with respect to environmental control in general (to be assessed by the auditor, based on his knowledge of the entity in general)?
12. Does the entity's operating structure include assigning responsibility, including segregation of duties, to specified individuals for environmental control?
13. Does the entity maintain an environmental information system, based on requirements by regulators or the entity's own evaluation of environmental risks? This system may provide, for example, information about physical quantities of emissions and hazardous waste, eco-balances, environmental characteristics of the entity's products and services, results from inspections performed by enforcement agencies, information about the occurrence and effects of incidents, and the number of complaints made by stakeholders.
14. Does the entity operate an Environmental Management System (EMS)? If so, has the EMS been certified by an independent certification body? Examples of recognized standards for an EMS are the international standard ISO 14001 and the European Commission's Eco-Management and Audit Scheme (EMAS).
15. Has the entity (voluntarily) published an environmental performance report? If so, has it been verified by an independent third party?
16. Are control procedures in place to identify and assess environmental risk, to monitor compliance with environmental laws and regulations, and to monitor possible changes in environmental legislation likely to impact the entity?
17. Does the entity have control procedures to deal with complaints about environmental matters, including health problems, from employees or third parties?
18. Does the entity operate control procedures for handling and disposal of hazardous waste, in compliance with legal requirements?
19. Are control procedures in place to identify and assess environmental hazards associated with the entity's products and services and the proper communication of information to customers about required preventive measures, if necessary?
20. Is management aware of the existence, and the potential impact on the entity's financial statements, of:
 - Any risk of liabilities arising as a result of contamination of soil, groundwater, or surface water;
 - Any risk of liabilities arising as a result of air pollution; or

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- Unresolved complaints about environmental matters from employees or third parties?

Appendix 2

Substantive Procedures to Detect a Material Misstatement due to Environmental Matters

The purpose of this appendix is to provide examples of substantive procedures that an auditor may perform to detect a material misstatement due to environmental matters.

These examples are included for illustrative purposes only. It is not intended that all of the procedures illustrated will be appropriate in any particular case. The procedures need to be tailored to fit the particular circumstances of each engagement. In some cases, the auditor may judge it unnecessary to perform any of these procedures.

It may be necessary for the auditor to consult an environmental expert when evaluating the results of substantive procedures with regard to environmental matters. The decision to involve an expert is a matter of professional judgment, governed by the circumstances and matters such as the technological situation, complexity and materiality of the items concerned.

General

Documentary Review in General

1. Consider minutes from board of directors' meetings, audit committees, or any other subcommittees of the board specifically responsible for environmental matters.
2. Consider publicly available industry information to consider any existing or possible future environmental matters. Also consider general available media comment, if any.
3. Where available, consider:
 - Reports issued by environmental experts about the entity, such as site assessments or environmental impact studies;
 - Internal audit reports;
 - "Environmental audit" reports;
 - Reports on due diligence investigations
 - Reports issued by and correspondence with regulatory agencies;
 - (Publicly available) registers or plans for the restoration of soil contamination;
 - Environmental performance reports issued by the entity;

- Correspondence with enforcement agencies; and
- Correspondence with the entity's lawyers.

Using the Work of Others

4. If an environmental expert is involved (for example, an expert has quantified the nature and extent of contamination, considering alternative methods of site restoration) and the outcome has been recognized or disclosed in the financial statements:
 - (a) Consider the impact of the results of the expert's work on the financial statements;
 - (b) Assess the professional competence and the objectivity of the environmental expert;
 - (c) Obtain sufficient appropriate audit evidence that the scope of the work of the environmental expert is adequate for the purposes of the audit of the financial statements; and
 - (d) Assess the appropriateness of the expert's work as audit evidence.
5. If the internal auditor has addressed certain environmental aspects of the entity's operations as part of the internal audit, consider the appropriateness of the work of the internal auditors for the purpose of the audit of the financial statements, applying the criteria set out in ISA 610 "Considering the Work of Internal Auditing"
6. If an "environmental audit" has been performed and the findings of that audit could qualify as audit evidence in the audit of the financial statements:⁷
 - (a) Consider the impact of the results of the "environmental audit" on the financial statements;
 - (b) Assess the professional competence and the objectivity of the "environmental auditor"/audit team;
 - (c) Obtain sufficient appropriate audit evidence that the scope of "environmental audit" is adequate for the purposes of the audit of the financial statements; and
 - (d) Assess the appropriateness of the work of the "environmental auditor" as audit evidence.

Insurance

7. Inquire about existing (and earlier) insurance cover for environmental risk and discuss this with management.

⁷ "Environmental audit": see paragraph 45.

Representations From Management

8. Obtain written representations from management that it has considered the effects of environmental matters on the financial statements, and that it:
 - (a) Is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts;
 - (b) Is not aware of environmental matters that may result in a material impairment of assets; or
 - (c) If aware of such matters, has disclosed to the auditor all facts related to them.

Subsidiaries

9. Inquire of auditors of subsidiaries as to the subsidiary's compliance with relevant local environmental laws and regulations and their possible effects on their financial statements.

Assets*Purchases of Land, Plant and Machinery*

10. For purchases of land, plant, and machinery made during the period (either directly by the entity, or indirectly through the acquisition of a subsidiary), inquire about the due diligence procedures management conducted to consider the effects of environmental matters in establishing a purchase price, taking into account the findings of remedial investigations and site restoration obligations.

Long-term Investments

11. Read, and discuss with those responsible, financial statements underlying long-term investments and consider the effect of any environmental matters discussed in these statements on the valuation of the investments.

Asset Impairment

12. Inquire about any planned changes in capital assets, for example, in response to changes in environmental legislation or changes in business strategy, assess their influences on the valuation of these assets or the company as a whole.
13. Inquire about policies and procedures to assess the need to write-down the carrying amount of an asset in situations where an asset impairment has occurred due to environmental matters.
14. Inquire about data gathered on which to base estimates and assumptions developed about the most likely outcome to determine the write-down due to the asset impairment.

15. Inspect the documentation supporting the amount of possible asset impairment and discuss such documentation with management.
16. For any asset impairments related to environmental matters that existed in previous periods, consider whether the assumptions underlying a write-down of related carrying values continue to be appropriate.

Recoverability of Claims

17. Review the recoverability of claims with respect to environmental matters that are included in the financial statements.

Liabilities, Provisions and Contingencies

Completeness of Liabilities, Provisions and Contingencies

18. Inquire about policies and procedures implemented to help identify liabilities, provisions or contingencies arising from environmental matters.
19. Inquire about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters, for example,
 - Violations of environmental laws and regulations;
 - Citations or penalties arising from violations of environmental laws and regulations; or
 - Claims and possible claims for environmental damage.
20. If site clean-up costs, future removal or site restoration costs or penalties arising from noncompliance with environmental laws and regulations have been identified, inquire about any related claims or possible claims.
21. Inquire about, read, and evaluate correspondence from regulatory authorities relating to matters dealing with environmental matters and consider whether such correspondence indicates liabilities, provisions or contingencies.
22. For property abandoned, purchased, or closed during the period, inquire about requirements for site clean-up or intentions for future removal and site restoration.
23. For property sold during the period (and in prior periods), inquire about any liabilities relating to environmental matters retained by contract or by law.
24. Perform analytical procedures and consider, as far as practicable, the relationships between financial information and quantitative information included in the entity's environmental records (for example, the relationship between raw materials consumed or energy used, and waste production or emissions, taking into account the entity's liabilities for proper waste disposal or maximum emission levels).

Accounting Estimates

25. Review and test the process used by management to develop accounting estimates and disclosures:
 - (a) Consider the adequacy of the work performed by environmental experts engaged by management, if any, applying the criteria set out in ISA 620 “Using the Work of an Expert;
 - (b) Review the data gathered on which estimates have been based;
 - (c) Consider whether the data are relevant, reliable and sufficient for the purpose;
 - (d) Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data;
 - (e) Consider whether changes in the business or industry may cause other factors to become significant to the assumptions;
 - (f) Consider the need to engage an environmental expert regarding the review of certain assumptions;
 - (g) Test the calculations made by management to translate the assumptions into the accounting estimate; and
 - (h) Consider whether top-management has reviewed and approved material accounting estimates with respect to environmental matters.
26. If management’s estimates are not appropriate, obtain an independent estimate to corroborate the reasonableness of management’s estimate.
27. For liabilities, provisions, or contingencies related to environmental matters consider whether the assumptions underlying the estimates continue to be appropriate.
28. Compare estimates of liabilities relating to one location (for example, estimates for site restoration or future removal and site restoration costs at a specific location) with:
 - (a) Estimates of liabilities for other locations with similar environmental problems;
 - (b) Actual costs incurred for other similar locations; or
 - (c) Estimates of costs of environmental liabilities reflected in the sales price for similar locations sold during the period.

Documentary Review

29. Inspect and evaluate the documentation supporting the amount of the environmental liability, provision or contingency and discuss such documentation with those responsible for it, such as:

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- Site clean-up or restoration studies;
- Quotes obtained for site clean-up or future removal and site restoration costs; and
- Correspondence with legal counsel as to the amount of a claim or the amount of penalties.

Disclosure

30. Review the adequacy of the disclosure of the effects of environmental matters on the financial statements.

**INTERNATIONAL AUDITING
PRACTICE STATEMENT 1012**

AUDITING DERIVATIVE FINANCIAL INSTRUMENTS

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International Auditing Practices Statements (Statements) are issued by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants to provide practical assistance to auditors in implementing the International Standards on Auditing (ISAs) or to promote good practice. Statements do not have the authority of ISAs.

This Statement does not establish any new basic principles or essential procedures; its purpose is to assist auditors, and to develop good practice, by providing guidance on the application of the ISAs when derivative activities are material to the financial statements of the entity. The auditor exercises professional judgment to determine the extent to which any of the audit procedures described in this Statement may be appropriate in the light of the requirements of the ISAs and the entity's particular circumstances.

The International Auditing Practices Committee approved this International Auditing Practice Statement for publication in March 2001.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where no PSP is added, the IAPS is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Auditing Practice Statement (IAPS) is to provide guidance to the auditor in planning and performing auditing procedures for financial statement assertions related to derivative financial instruments. This IAPS focuses on auditing derivatives held by end users, including banks and other financial sector entities when they are the end users. An end user is an entity that enters into a financial transaction, through either an organized exchange or a broker, for the purpose of hedging, asset/liability management or speculating. End users consist primarily of corporations, government entities, institutional investors and financial institutions. An end user's derivative activities often are related to the entity's production or use of a commodity. The accounting systems and internal control issues associated with issuing or trading derivatives may be different from those associated with using derivatives. IAPS 1006, "The Audit of International Commercial Banks," provides guidance on the audits of banks and other financial-sector entities, and includes guidance on auditing international commercial banks issuing or trading derivatives.

Derivative Instruments and Activities

2. Derivative financial instruments are becoming more complex, their use is becoming more commonplace and the accounting requirements to provide fair value and other information about them in financial statement presentations and disclosures are expanding. Values of derivatives may be volatile. Large and sudden decreases in their value may increase the risk that a loss to an entity using derivatives may exceed the amount, if any, recorded on the balance sheet. Furthermore, because of the complexity of derivative activities, management may not fully understand the risks of using derivatives.
3. For many entities, the use of derivatives has reduced exposures to changes in exchange rates, interest rates and commodity prices, as well as other risks. On the other hand, the inherent characteristics of derivative activities and derivative financial instruments also may result in increased business risk in some entities, in turn increasing audit risk and presenting new challenges to the auditor.
4. "Derivatives" is a generic term used to categorize a wide variety of financial instruments whose value "depends on" or is "derived from" an underlying rate or price, such as interest rates, exchange rates, equity prices, or commodity prices. Derivative contracts can be linear or non-linear. They are contracts that either involve obligatory cash flows at a future date (linear) or have option features where one party has the right but not the obligation to demand that another party deliver the underlying item to it (non-linear). Some national financial reporting frameworks, and the International Accounting Standards contain definitions of derivatives. For example, International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement," defines a derivative as a financial instrument:

- Whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the “underlying”);
- That requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
- That is settled at a future date.

In addition, different national financial reporting frameworks and the International Accounting Standards provide for different accounting treatments of derivative financial instruments.

5. The most common linear contracts are forward contracts (for example, foreign exchange contracts and forward rate agreements), futures contracts (for example, a futures contract to purchase a commodity such as oil or power) and swaps. The most common non-linear contracts are options, caps, floors and swaptions. Derivatives that are more complex may have a combination of the characteristics of each category.
6. Derivative activities range from those whose primary objective is to:
 - Manage current or anticipated risks relating to operations and financial position; or
 - Take open or speculative positions to benefit from anticipated market movements.

Some entities may be involved in derivatives not only from a corporate treasury perspective but also, or alternatively, in association with the production or use of a commodity.

7. While all financial instruments have certain risks, derivatives often possess particular features that leverage the risks, such as:
 - Little or no cash outflows/inflows are required until maturity of the transactions;
 - No principal balance or other fixed amount is paid or received;
 - Potential risks and rewards can be substantially greater than the current outlays; and

The value of an entity’s asset or liability may exceed the amount, if any, of the derivative that is recognized in the financial statements, especially in entities whose financial reporting frameworks do not require derivatives to be recorded at fair market value in the financial statements.

Responsibilities of Management and Those Charged with Governance

8. ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” states that the entity’s management is responsible for preparing and presenting financial statements. As part of the process of preparing those financial statements, management makes specific assertions related to derivatives. Those assertions include (where the financial reporting framework requires) that all derivatives recorded in the financial statements exist, that there are no unrecorded derivatives at the balance sheet date, that the derivatives recorded in the financial statements are properly valued, and presented, and that all relevant disclosures are made in the financial statements.
9. Those charged with governance of an entity, through oversight of management, are responsible for:
 - The design and implementation of a system of internal control to:
 - Monitor risk and financial control;
 - Provide reasonable assurance that the entity’s use of derivatives is within its risk management policies; and
 - Ensure that the entity is in compliance with applicable laws and regulations; and
 - The integrity of the entity’s accounting and financial reporting systems to ensure the reliability of management’s financial reporting of derivative activities.
10. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The Auditor’s Responsibility

11. ISA 200 states that the objective of the audit is to enable the auditor to express an opinion on whether the financial statements are prepared in all material respects, in accordance with an identified financial reporting framework. The auditor’s responsibility related to derivative financial instruments, in the context of the audit of the financial statements taken as a whole, is to consider whether management’s assertions related to derivatives result in financial statements prepared in all material respects in accordance with an identified financial reporting framework.
12. The auditor establishes an understanding with the entity that the purpose of the audit work is to be able to express an opinion on the financial statements. The purpose of an audit of financial statements is not to provide assurance on the adequacy of the entity’s risk management related to derivative activities, or the controls over those activities. To avoid any misunderstanding the auditor may discuss with management the nature and extent of the audit work related to derivative activities. ISA 210, “Terms of Audit Engagements,” provides guidance on agreeing upon the terms of the engagement with an entity.

The Need for Special Skill and Knowledge

13. ISA 200 requires that the auditor comply with the “Code of Ethics for Professional Accountants” issued by the International Federation of Accountants. Among other things, this code requires that the professional accountant perform professional services with competence and diligence. The code further requires that the auditor maintain sufficient professional knowledge and skill to fulfill responsibilities with due care.
14. To comply with the requirements of ISA 200, the auditor may need special skills or knowledge to plan and perform auditing procedures for certain assertions about derivatives. Special skills and knowledge include obtaining an understanding of:
 - The operating characteristics and risk profile of the industry in which an entity operates;
 - The derivative financial instruments used by the entity, and their characteristics;
 - The entity’s information system for derivatives, including services provided by a service organization. This may require the auditor to have special skills or knowledge about computer applications when significant information about those derivatives is transmitted, processed, maintained or accessed electronically;
 - The methods of valuation of the derivative, for example, whether fair value is determined by quoted market price, or a pricing model; and
 - The requirements of the financial reporting framework for financial statement assertions related to derivatives. Derivatives may have complex features that require the auditor to have special knowledge to evaluate their measurement, recognition and disclosure in conformity with the financial reporting framework. For example, features embedded in contracts or agreements may require separate accounting, and complex pricing structures may increase the complexity of the assumptions used in measuring the instrument at fair value. In addition, the requirements of the financial reporting framework may vary depending on the type of derivative, the nature of the transaction, and the type of entity.
15. Members of the engagement team may have the necessary skill and knowledge to plan and perform auditing procedures related to derivatives transactions. Alternatively, the auditor may decide to seek the assistance of an expert outside the firm, with the necessary skills or knowledge to plan and perform the auditing procedures, especially when the derivatives are very complex, or when simple derivatives are used in complex situations, the entity is engaged in active trading of derivatives, or the valuation of the derivatives are based on complex pricing models. ISA 220, “Quality Control for Audit Work,” provides guidance on the supervision of individuals who serve as members of the engagement team and assist the auditor in planning and performing auditing

procedures. ISA 620, “Using the Work of an Expert,” provides guidance on the use of an expert’s work as audit evidence.

Knowledge of the Business

16. ISA 310, “Knowledge of the Business,” requires the auditor, in performing an audit of financial statements, to have or obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor’s judgment, may have a significant effect on the financial statements, the examination or the audit report. For example, the auditor uses such knowledge to assess inherent and control risks and to determine the nature, timing and extent of audit procedures.
17. Because derivative activities generally support the entity’s business activities, factors affecting its day-to-day operations also will have implications for its derivative activities. For example, because of the economic conditions that affect the price of an entity’s primary raw materials, an entity may enter into a futures contract to hedge the cost of its inventory. Similarly, derivative activities can have a major effect on the entity’s operations and viability.

General Economic Factors

18. General economic factors are likely to have an influence on the nature and extent of an entity’s derivative activities. For example, when interest rates appear likely to rise, an entity may try to fix the effective level of interest rates on its floating rate borrowings through the use of interest rate swaps, forward rate agreements and caps. General economic factors that may be relevant include:
 - The general level of economic activity;
 - Interest rates, including the term structure of interest rates, and availability of financing;
 - Inflation and currency revaluation;
 - Foreign currency rates and controls; and
 - The characteristics of the markets that are relevant to the derivatives used by the entity, including the liquidity or volatility of those markets.

The Industry

19. Economic conditions in the entity’s industry also are likely to influence the entity’s derivative activities. If the industry is seasonal or cyclical, it may be inherently more difficult to accurately forecast interest rate, foreign exchange or liquidity exposures. A high growth rate or sharp rate of decline in an entity’s business also may make it difficult to predict activity levels in general and, thus, its level of derivative activity. Economic conditions in a particular industry that may be relevant include:

- The price risk in the industry;
- The market and competition;
- Cyclical or seasonal activity;
- Declining or expanding operations;
- Adverse conditions (for example, declining demand, excess capacity, serious price competition); and
- Foreign currency transactions, translation or economic exposure.

The Entity

20. To obtain a sufficient understanding of an entity's derivative activities, to be able to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report, the auditor considers:
 - *Knowledge and experience of management and those charged with governance.* Derivative activities can be complicated and often, only a few individuals within an entity fully understand these activities. In entities that engage in few derivative activities, management may lack experience with even relatively simple derivative transactions. Furthermore, the complexity of various contracts or agreements makes it possible for an entity to inadvertently enter into a derivative transaction. Significant use of derivatives, particularly complex derivatives, without relevant expertise within the entity increases inherent risk. This may prompt the auditor to question whether there is adequate management control, and may affect the auditor's risk assessment and the nature, extent and timing of audit testing considered necessary;
 - *Availability of timely and reliable management information.* The control risk associated with derivative activities may increase with greater decentralization of those activities. This especially may be true where an entity is based in different locations, some perhaps in other countries. Derivative activities may be run on either a centralized or a decentralized basis. Derivative activities and related decision making depend heavily on the flow of accurate, reliable, and timely management information. The difficulty of collecting and aggregating such information increases with the number of locations and businesses in which an entity is involved;
 - *Objectives for the use of derivatives.* Derivative activities range from those whose primary objective is to reduce or eliminate risk (hedging) to those whose primary objective is to maximize profits (speculating). All other things being equal, risk increases as maximizing profits becomes the focus of derivative activity. The auditor gains an understanding of the strategy behind the entity's use of derivatives and identifies where the entity's derivative activities lie on the hedging-speculating continuum.

Key Financial Risks

21. The auditor obtains an understanding of the principal types of financial risk, related to derivative activities, to which entities may be exposed. Those key financial risks are:

(a) *Market risk*, which relates broadly to economic losses due to adverse changes in the fair value of the derivative. Related risks include:

- Price risk, which relates to changes in the level of prices due to changes in interest rates, foreign exchange rates, or other factors related to market volatilities of the underlying rate, index, or price. Price risk includes interest rate risk and foreign exchange risk;
- Liquidity risk, which relates to changes in the ability to sell or dispose of the derivative instrument. Derivative activities bear the additional risk that a lack of available contracts or counterparties may make it difficult to close out the derivative transaction or enter into an offsetting contract. For example, liquidity risk may increase if an entity encounters difficulties obtaining the required security or commodity or other deliverable should the derivative call for physical delivery.

Economic losses also may occur if the entity makes inappropriate trades based on information obtained using poor valuation models.

Derivatives used in hedging transactions bear additional risk, known as basis risk. Basis is the difference between the price of the hedged item and the price of the related hedging instrument. Basis risk is the risk that the basis will change while the hedging contract is open, and thus, the price correlation between the hedged item and the hedging instrument will not be perfect. For example, basis risk may be affected by a lack of liquidity in either the hedged item, or the hedging instrument;

(b) *Credit risk*, which relates to the risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. For certain derivatives, market values are volatile, so the credit risk exposure also is volatile. Generally, a derivative has credit exposure only when the derivative has positive market value. That value represents an obligation of the counterparty and, therefore, an economic benefit that can be lost if the counterparty fails to fulfill its obligation. Furthermore, the market value of a derivative may fluctuate quickly, alternating between positive and negative values. The potential for rapid changes in prices, coupled with the structure of certain derivatives, also can affect credit risk exposure. For example, highly leveraged derivatives or derivatives with extended time periods can result in credit risk exposure increasing quickly after a derivative transaction has been undertaken.

Many derivatives are traded under uniform rules through an organized exchange (exchange-traded derivatives). Exchange traded derivatives generally remove individual counterparty risk and substitute the clearing organization as the settling counterparty. Typically, the participants in an exchange-traded derivative settle changes in the value of their positions daily, which further mitigates credit risk. Other methods for minimizing credit risk include requiring the counterparty to offer collateral, or assigning a credit limit to each counterparty based on its credit rating.

- (c) *Settlement risk* is the related risk that one side of a transaction will be settled without value being received from the customer or counterparty. One method for minimizing settlement risk is to enter into a master netting agreement, which allows the parties to set off all their related payable and receivable positions at settlement;
- (d) *Solvency risk*, which relates to the risk that the entity would not have the funds available to honor cash outflow commitments as they fall due. For example, an adverse price movement on a futures contract may result in a margin call that the entity may not have the liquidity to meet;
- (e) *Legal risk*, which relates to losses resulting from a legal or regulatory action that invalidates or otherwise precludes performance by the end user or its counterparty under the terms of the contract or related netting arrangements. For example, legal risk could arise from insufficient documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities from investing in certain types of derivatives.

Although other classifications of risk exist, they are normally combinations of these principal risks. There is also a further risk for commodities in that their quality may not meet expectations.

Assertions to Address

22. Financial statement assertions are assertions by management, explicit or otherwise, embodied in the financial statements prepared in accordance with the applicable financial reporting framework. They can be categorized as follows:
 - *Existence*: An asset or liability exists at a given date. For example, the derivatives reported in the financial statements through measurement or disclosure exist at the date of the balance sheet;
 - *Rights and obligations*: An asset or a liability pertains to the entity at a given date. For example, an entity has the rights and obligations associated with the derivatives reported in the financial statements;
 - *Occurrence*: A transaction or event took place that pertains to the entity during the period. For example, the transaction that gave rise to the derivative occurred within the financial reporting period;

- *Completeness:* There are no unrecorded assets, liabilities, transactions or events, or undisclosed items. For example, all of the entity's derivatives are reported in the financial statements through measurement or disclosure;
- *Valuation:* An asset or liability is recorded at an appropriate carrying value. For example, the values of the derivatives reported in the financial statements through measurement or disclosure were determined in accordance with the financial reporting framework;
- *Measurement:* A transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period. For example, the amounts associated with the derivatives reported in the financial statements through measurement or disclosure were determined in accordance with the financial reporting framework, and the revenues or expenses associated with the derivatives reported in the financial statements were allocated to the correct financial reporting periods; and
- *Presentation and disclosure:* An item is disclosed, classified and described in accordance with the applicable financial reporting framework. For example, the classification, description and disclosure of derivatives in the financial statements are in accordance with the financial reporting framework.

Risk Assessment and Internal Control

23. Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk. The auditor considers knowledge obtained about the business and about the key financial risks in assessing the components of audit risk.
24. ISA 400, "Risk Assessments and Internal Control," provides guidance on the auditor's consideration of audit risk and internal control when planning and performing an audit of financial statements in accordance with ISAs. The ISA requires that the auditor use professional judgment to assess audit risk and to design audit procedures to ensure that risk is reduced to an acceptably low level. It also requires the auditor to obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach.

Inherent Risk

25. Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal control.
26. ISA 400 requires that, in developing the overall audit plan, the auditor assess the inherent risk at the financial statement level. ISA 400 requires the auditor

to relate that assessment to material account balances and classes of transactions at the assertion level, or assume that inherent risk is high for the assertion.

27. ISA 400 provides guidance to the auditor in using professional judgment to evaluate numerous factors that may affect the assessment of inherent risk. Examples of factors that might affect the auditor's assessment of the inherent risk for assertions about derivatives include:
- *Economics and business purpose of the entity's derivative activities.* The auditor understands the nature of the entity's business and the economics and business purpose of its derivative activities, all of which may influence the entity's decision to buy, sell or hold derivatives;
 - Derivative activities range from positions where the primary aim is to reduce or eliminate risk (hedging), to positions where the primary aim is to maximize profits (speculating). The inherent risks associated with risk management differ significantly from those associated with speculative investing;
 - *The complexity of a derivative's features.* Generally, the more complex a derivative, the more difficult it is to determine its fair value. The fair values of certain derivatives, such as exchange-traded options, are available from independent pricing sources such as financial publications and broker-dealers not affiliated with the entity. Determining fair value can be particularly difficult, however, if a transaction has been customized to meet individual user needs. When derivatives are not traded regularly, or are traded only in markets without published or quoted market prices, management may use a valuation model to determine fair value. Valuation risk is the risk that the fair value of the derivative is determined incorrectly. Model risk, which is a component of valuation risk, exists whenever models (as opposed to quoted market prices) are used to determine the fair value of a derivative. Model risk is the risk associated with the imperfections and subjectivity of these models and their related assumptions. Both valuation risk and model risk contribute to the inherent risk for the valuation assertion about those derivatives;
 - *Whether the transaction giving rise to the derivative involved the exchange of cash.* Many derivatives do not involve an exchange of cash at the inception of the transaction, or may involve contracts that have irregular or end of term cash flows. There is an increased risk that such contracts will not be identified, or will be only partially identified and recorded in the financial statements, increasing the inherent risk for the completeness assertion about those derivatives;
 - *An entity's experience with the derivative.* Significant use of complex derivatives without relevant expertise within the entity increases inherent risk. Relevant expertise should reside with the personnel involved with the entity's derivative activities, including those charged with governance,

those committing the entity to the derivative transactions (hereinafter referred to as “dealers”), those involved with risk control and the accounting and operations personnel responsible for recording and settling the transactions. In addition, management may be more likely to overlook infrequent transactions for relevant accounting and disclosure issues;

- *Whether the derivative is an embedded feature of an agreement.* Management may be less likely to identify embedded derivatives, which increases the inherent risk for the completeness assertion about those derivatives;
- *Whether external factors affect the assertion.* For example, the increase in credit risk associated with entities operating in declining industries increases the inherent risk for the valuation assertion about those derivatives. In addition, significant changes in, or volatility of, interest rates increase the inherent risk for the valuation of derivatives whose value is significantly affected by interest rates;
- *Whether the derivative is traded on national exchanges or across borders.* Derivatives traded in cross-border exchanges may be subject to increased inherent risk because of differing laws and regulations, exchange rate risk, or differing economic conditions. These conditions may contribute to the inherent risk for the rights and obligations assertion or the valuation assertion.

28. Many derivatives have the associated risk that a loss might exceed the amount, if any, of the value of the derivative recognized on the balance sheet (off-balance-sheet risk). For example, a sudden fall in the market price of a commodity may force an entity to realize losses to close a forward position in that commodity. In some cases, the potential losses may be enough to cast significant doubt on the entity’s ability to continue as a going concern. ISA 570, “Going Concern,” establishes standards and provides guidance on the auditor’s responsibility in the audit of financial statements with respect to the going concern assumption used in the preparation of the financial statements. The entity may perform sensitivity analyses or value-at-risk analyses to assess the hypothetical effects on derivative instruments subject to market risks. The auditor may consider these analyses in evaluating management’s assessment of the entity’s ability to continue as a going concern.

Accounting Considerations

29. An entity’s accounting method affects specific audit procedures and is, therefore, significant. The accounting for derivatives may depend whether the derivative has been classified as a hedging instrument, and if the hedging relationship is a highly effective one. For example, IAS 39 requires the entity to recognize the changes in fair value of a derivative instrument as net profit or loss in the current period. If a derivative is part of a hedging relationship that meets certain criteria, the hedging relationship qualifies for special hedge

accounting, which recognizes the offsetting effects of the hedged item on net profit or loss. Because the derivatives and hedged item are economically connected, it is appropriate to recognize derivative gains or losses in the same accounting period that the gains or losses on the hedged item are recognized. For some transactions, changes in fair value will appear as a component of current net profit or loss. For other transactions, changes in fair value will appear currently in changes in equity, and ultimately, when the final transactions occurs, in net profit or loss.

30. Derivatives used as hedges are subject to the risk that market conditions will change so that the hedge is no longer effective and, thus, no longer meets the conditions of a hedging relationship. For example, IAS 39 requires that periodic gains and losses on a futures contract used to hedge the future purchase of inventory be recognized as changes in stockholders' equity, with the cumulative gains or losses appearing in net profit or loss in the same period(s) that the hedged forecasted transaction affects net profit or loss. Any discrepancies between changes in the spot price of the futures contract and the corollary changes in the cost of the related inventory purchase would reduce the effectiveness of the hedge. Discrepancies may be caused by differing delivery sites for an inventory purchase and futures contract used to hedge the inventory purchase. For example, the cost of physical delivery may vary depending on site. Other discrepancies may be caused by differing time parameters between the execution of the hedged item and the hedging instrument, or differing quality or quantity measures involving the hedged item and those specified in the hedging instrument. IAS 39 requires the ineffective portion of a change in the value of a hedging instrument to be reported immediately in net profit or loss. If the hedge is assessed and determined not to be highly effective, the hedging relationship would no longer meet the criteria for hedge accounting. Continued hedge accounting would exclude gains and losses improperly from net profit or loss for the period. The complexities of the accounting for derivatives increase the inherent risk for the presentation and disclosure assertion about those derivatives.

Accounting System Considerations

31. ISA 400 requires that the auditor obtain an understanding of the accounting system. To achieve this understanding, the auditor obtains knowledge of the design of the accounting system, changes to that system and its operation. The extent of an entity's use of derivatives and the relative complexity of the instruments are important determinants of the necessary level of sophistication of both the entity's information systems (including the accounting system) and control procedures.
32. Certain instruments may require a large number of accounting entries. Although the accounting system used to post derivative transactions likely will need some manual intervention, ideally, the accounting system is able to post such entries accurately with minimal manual intervention. As the sophistication of the derivative activities increases, so should the

sophistication of the accounting system. Because this is not always the case, the auditor remains alert to the possible need to modify the audit approach if the quality of the accounting system, or aspects of it, appears weak.

Control Environment

33. The control environment influences the tone of an entity and the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. The control environment has a pervasive influence on the way business activities are structured, objectives established and risks assessed.
34. ISA 400 requires the auditor to obtain an understanding of the control environment sufficient to assess the attitudes of management and those charged with governance, their awareness and actions regarding internal control and its importance in the entity.
35. The auditor considers management's overall attitude toward, and awareness of, derivative activities as a part of obtaining an understanding of the control environment, including any changes to it. It is the role of those charged with governance to determine an appropriate attitude towards the risks. It is management's role to monitor and manage the entity's exposures to those risks. The auditor obtains an understanding of how the control environment for derivatives responds to management's assessment of risk. To effectively monitor and manage its exposure to risk, an entity implements a structure that:
 - Is appropriate and consistent with the entity's attitude toward risk as determined by those charged with governance;
 - Specifies the approval levels for the authorization of different types of instruments and transactions that may be entered into and for what purposes. The permitted instruments and approval levels should reflect the expertise of those involved in derivative activities;
 - Sets appropriate limits for the maximum allowable exposure to each type of risk (including approved counterparties). Levels of allowable exposure may vary depending on the type of risk, or counterparty;
 - Provides for the independent and timely monitoring of the financial risks and control procedures; and
 - Provides for the independent and timely reporting of exposures, risks and the results of derivative activities in managing risk.
36. Management should establish suitable guidelines to ensure that derivative activities fulfill the entity's needs. In setting suitable guidelines, management should include clear rules on the extent to which those responsible for derivative activities are permitted to participate in the derivative markets. Once this has been done, management can implement suitable systems to manage and control those risks. Three elements of the control environment

deserve special mention for their potential effect on controls over derivative activities:

- *Direction from management or those charged with governance.* Management is responsible for providing direction, through clearly stated policies, for the purchase, sale and holding of derivatives. These policies should begin with management clearly stating its objectives with regard to its risk management activities and an analysis of the investment and hedging alternatives available to meet those objectives. Policies and procedures should then be developed that consider the:
 - Level of the entity's management expertise;
 - Sophistication of the entity's internal control and monitoring systems;
 - Entity's asset/liability structure;
 - Entity's capacity to maintain liquidity and absorb losses of capital;
 - Types of derivative financial instruments that management believes will meet its objectives;
 - Uses of derivative financial instruments that management believes will meet its objectives, for example, whether derivatives may be used for speculative purposes or hedging purposes.

An entity's policies for the purchase, sale and holding of derivatives should be appropriate and consistent with its attitude toward risk and the expertise of those involved in derivative activities.

- *Segregation of duties and the assignment of personnel.* Derivative activities may be categorized into three functions:
 - Committing the entity to the transaction (dealing);
 - Initiating cash payments and accepting cash receipts (settlements); and
 - Recording of all transactions correctly in the accounting records, including the valuation of derivatives.

Segregation of duties should exist among these three functions. Where an entity is too small to achieve proper segregation of duties, management should take a more active role to monitor derivative activities.

Some entities have established a fourth function, *Risk Control*, which is responsible for reporting on and monitoring derivative activities. Examples of key responsibilities in this area may include:

- Setting and monitoring risk management policy;
- Designing risk limit structures;

- Developing disaster scenarios and subjecting open position portfolios to sensitivity analysis, including reviews of unusual movements in positions; and
- Reviewing and analyzing new derivative instrument products.

In entities that have not established a separate risk control function, reporting on and monitoring derivative activities may be a component of the accounting function's responsibility or management's overall responsibility.

- *Whether or not the general control environment has been extended to those responsible for derivative activities.* An entity may have a control culture that is generally focused on maintaining a high level of internal control. Because of the complexity of some treasury or derivative activities, this culture may not pervade the group responsible for derivative activities. Alternatively, because of the risks associated with derivative activities, management may enforce a more strict control environment than it does elsewhere within the entity.
37. Some entities may operate an incentive compensation system for those involved in derivative transactions. In such situations, the auditor considers the extent to which proper guidelines, limits and controls have been established to ascertain if the operation of that system could result in transactions that are inconsistent with the overall objectives of the entity's risk management strategy.
38. When an entity uses electronic commerce for derivative transactions, it should address the security and control considerations relevant to the use of an electronic network.

Control Objectives and Procedures

39. Internal controls over derivative transactions should prevent or detect problems that hinder an entity from achieving its objectives. These objectives may be either operational, financial reporting, or compliance in nature, and internal control is necessary to prevent or detect problems in each area.
40. ISA 400 requires the auditor to obtain an understanding of the control procedures sufficient to plan the audit. Effective control procedures over derivatives generally will include adequate segregation of duties, risk management monitoring, management oversight, and other policies and procedures designed to ensure that the entity's control objectives are met. Those control objectives include:
- *Authorized execution.* Derivative transactions are executed in accordance with the entity's approved policies.
 - *Complete and accurate information.* Information relating to derivatives, including fair value information, is recorded on a timely basis, is complete and accurate when entered into the accounting system, and has been properly classified, described and disclosed.

- *Prevention or detection of errors.* Misstatements in the processing of accounting information for derivatives are prevented or detected in a timely manner.
- *Ongoing monitoring.* Activities involving derivatives are monitored on an ongoing basis to recognize and measure events affecting related financial statement assertions.
- *Valuation.* Changes in the value of derivatives are appropriately accounted for and disclosed to the right people from both an operational and a control viewpoint. Valuation may be a part of ongoing monitoring activities.

In addition, for derivatives designated as hedges, internal controls should assure that those derivatives meet the criteria for hedge accounting, both at the inception of the hedge, and on an ongoing basis.

41. As it relates to the purchase, sale and holding of derivatives, the level of sophistication of an entity's internal control will vary according to:
 - The complexity of the derivative and the related inherent risk—more complex derivative activities will require more sophisticated systems;
 - The risk exposure of derivative transactions in relation to the capital employed by the entity; and
 - The volume of transactions—entities that do not have a significant volume of derivative transactions will require less sophisticated accounting systems and internal control.
42. As the sophistication of derivative activity increases, so should internal control. In some instances, an entity will expand the types of financial activities it enters into without making corresponding adjustments to its internal control.
43. In larger entities, sophisticated computer information systems generally keep track of derivative activities, and to ensure that settlements occur when due. More complex computer systems may generate automatic postings to clearing accounts to monitor cash movements. Proper controls over processing will help to ensure that derivative activities are correctly reflected in the entity's records. Computer systems may be designed to produce exception reports to alert management to situations where derivatives have not been used within authorized limits or where transactions undertaken were not within the limits established for the chosen counterparties. Even a sophisticated computer system may not ensure the completeness of derivative transactions.
44. Derivatives, by their very nature, can involve the transfer of sizable amounts of money both to and from the entity. Often, these transfers take place at maturity. In many instances, a bank is only provided with appropriate payment instructions or receipt notifications. Some entities may use electronic fund transfer systems. Such systems may involve complex password and

verification controls, standard payment templates and cash pooling/sweeping facilities. ISA 401, “Auditing in a Computer Information Systems Environment,” requires the auditor to consider how computer information systems (CIS) environments affect the audit and to obtain an understanding of the significance and complexity of the CIS activities and the availability of data for use in the audit. The auditor gains an understanding of the methods used to transfer funds, along with their strengths and weaknesses, as this will affect the risks the business is faced with and accordingly, the audit risk assessment.

45. Regular reconciliations are an important aspect of controlling derivative activities. Formal reconciliations should be performed on a regular basis to ensure that the financial records are properly controlled, all entries are promptly made and the dealers have adequate and accurate position information before formally committing the entity to a legally binding transaction. Reconciliations should be properly documented and independently reviewed. The following are some of the more significant types of reconciliation procedures associated with derivative activities.
 - Reconciliation of dealers’ records to records used for the ongoing monitoring process and the position or profit and loss shown in the general ledger.
 - Reconciliation of subsidiary ledgers, including those maintained on computerized data bases, to the general ledger;
 - Reconciliation of all clearing and bank accounts and broker statements to ensure all outstanding items are promptly identified and cleared.
 - Reconciliation of entity’s accounting records to records maintained by service organizations, where applicable.
46. An entity’s deal initiation records should clearly identify the nature and purpose of individual transactions, and the rights and obligations arising under each derivative contract. In addition to the basic financial information, such as a notional amount, these records should include:
 - The identity of the dealer;
 - The identity of the person recording the transaction, if that person is not the dealer;
 - The date and time of the transaction;
 - The nature and purpose of the transaction, including whether or not it is intended to hedge an underlying commercial exposure; and
 - Information on compliance with accounting requirements related to hedging, if applicable, such as:
 - Designation as a hedge, including the type of hedge;

- Identification of the criteria used for assessing effectiveness of the hedge; and
 - Identification of the hedged item in a hedging relationship.
47. Transaction records for derivatives may be maintained in a database, register or subsidiary ledger, which are then checked for accuracy with independent confirmations received from the counterparties to the transactions. Often, the transaction records will be used to provide accounting information, including information for disclosures in the financial statements, together with other information to manage risk, such as exposure reports against policy limits. Therefore, it is essential to have appropriate controls over input, processing and maintenance of the transaction records, whether they are in a database, a register or a subsidiary ledger.
48. The main control over the completeness of the derivative transaction records is the independent matching of counterparty confirmations against the entity's own records. Counterparties should be asked to send the confirmations back directly to employees of the entity that are independent from the dealers, to guard against dealers suppressing confirmations and "hiding" transactions, and all details should be checked off against the entity's records. Employees independent of the dealer should resolve any exceptions contained in the confirmations, and fully investigate any confirmation that is not received.

The Role of Internal Auditing

49. As part of the assessment of internal control, the auditor considers the role of internal auditing. The knowledge and skills required to understand and audit an entity's use of derivatives are generally quite different from those needed in auditing other parts of the business. The external auditor considers the extent to which the internal audit function has the knowledge and skill to cover, and has in fact covered, the entity's derivatives activities.
50. In many entities, internal auditing forms an essential part of the risk control function that enables senior management to review and evaluate the control procedures covering the use of derivatives. The work performed by internal auditing may assist the external auditor in assessing the accounting systems and internal controls and therefore control risk. Areas where the work performed by internal auditing may be particularly relevant are:
- Developing a general overview of the extent of derivative use;
 - Reviewing the appropriateness of policies and procedures and management's compliance with them;
 - Reviewing the effectiveness of control procedures;
 - Reviewing the accounting systems used to process derivative transactions;
 - Reviewing systems relevant to derivative activities;

- Ensuring that objectives for derivative management are fully understood across the entity, particularly where there are operating divisions where the risk exposures are most likely to arise;
 - Assessing whether new risks relating to derivatives, are being identified, assessed and managed;
 - Evaluating whether the accounting for derivatives is in accordance with the financial reporting framework including, if applicable, whether derivatives accounted for using hedge accounting specified by the financial reporting framework meet the conditions of a hedging relationship; and
 - Conducting regular reviews to:
 - Provide management with assurance that derivative activities are being properly controlled; and
 - Ensure that new risks and the use of derivatives to manage these risks are being identified, assessed and managed.
51. Certain aspects of internal auditing may be useful in determining the nature, timing and extent of external audit procedures. When it appears that this might be the case, the external auditor, during the course of planning the audit, obtains a sufficient understanding of internal audit activities and performs a preliminary assessment of the internal audit function. When the external auditor intends to use specific internal audit work, the external auditor evaluates and tests that work to confirm its adequacy for the external auditor's purposes. ISA 610, "Considering the Work of Internal Auditing," provides guidance to the external auditor in considering the work of internal auditing.

Service Organizations

52. Entities may use service organizations to initiate the purchase or sale of derivatives or maintain records of derivative transactions for the entity.
53. The use of service organizations may strengthen controls over derivatives. For example, a service organization's personnel may have more experience with derivatives than the entity's management. The use of the service organization also may allow for greater segregation of duties. On the other hand, the use of a service organization may increase risk because it may have a different control culture or process transactions at some distance from the entity.
54. ISA 402, "Audit Considerations Relating to Entities Using Service Organizations," provides guidance to the auditor when the entity being audited uses a service organization. ISA 402 requires the auditor to consider, when planning the audit and developing an effective audit approach, how using a service organization affects the entity's accounting and internal control systems. ISA 402 provides further guidance in auditing entities using service organizations. When applying ISA 402 to a service organization engaged in

derivative transactions, the auditor considers how a service organization affects the entity's accounting and internal control systems.

55. Because service organizations often act as investment advisors, the auditor may consider risks associated with service organizations when acting as investment advisors, including:
 - How their services are monitored;
 - The procedures in place to protect the integrity and confidentiality of the information;
 - Contingency arrangements; and
 - Any related party issues that may arise because the service organization can enter into its own derivative transactions with the entity while, at the same time, being a related party.

Control Risk

56. Control risk is the risk that an entity's accounting and internal control systems will not prevent or detect and correct, on a timely basis, any misstatements in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.
57. ISA 400 requires the auditor, after obtaining an understanding of the accounting and internal control systems, to make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions. The ISA requires the preliminary assessment of control risk for a financial statement assertion to be high unless the auditor:
 - (a) Is able to identify internal controls relevant to the assertion that are likely to prevent or detect and correct a material misstatement; and
 - (b) Plans to perform tests of control to support the assessment.
58. When developing the audit approach, the auditor considers the preliminary assessment of control risk (in conjunction with the assessment of inherent risk) to determine the nature, timing and extent of substantive procedures for the financial statement assertions.
59. Examples of considerations that might affect the auditor's assessment of control risk include:
 - Whether policies and procedures that govern derivative activities reflect management's objectives;
 - How management informs its personnel of controls;
 - How management captures information about derivatives; and
 - How management assures itself that controls over derivatives are operating as designed.

60. ISA 400 requires the auditor, before the conclusion of the audit, and based on the results of substantive procedures and other audit evidence obtained, to consider whether the assessment of control risk is confirmed.
61. The assessment of control risk depends on the auditor's judgment as to the quality of the control environment and the control procedures in place. In reaching a decision on the nature, timing and extent of testing of controls, the auditor considers factors such as:
 - The importance of the derivative activities to the entity;
 - The nature, free frequency and volume of derivatives transactions;
 - The potential effect of any identified weaknesses in control procedures;
 - The types of controls being tested;
 - The frequency of performance of these controls; and
 - The evidence of performance.

Tests of Controls

62. Where the assessment of control risk is less than high, the auditor performs tests of controls to obtain evidence as to whether or not the preliminary assessment of control risk is supported. Notwithstanding the auditor's assessment of control risk, it may be that the entity undertakes only a limited number of derivative transactions, or that the magnitude of these instruments is especially significant to the entity as a whole. In such instances, a substantive approach, sometimes in combination with tests of control, may be more appropriate.
63. The population from which items are selected for detailed testing is not limited to the accounting records. Tested items may be drawn from other sources, for example counterparty confirmations and trader tickets, so that the possibility of overlooking transactions in the recording procedure can be tested.
64. Tests of controls are performed to obtain audit evidence about the effectiveness of the: (a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements and (b) operation of the internal controls throughout the period. Key procedures may include evaluating, for a suitably sized sample of transactions, whether:
 - Derivatives have been used in accordance with the agreed policies, guidelines and within authority limits;
 - Appropriate decision-making processes have been applied and the reasons behind entering into selected transactions are clearly understandable;
 - The transactions undertaken were within the policies for derivative transactions, including terms and limits and transactions with foreign or related parties;

- The transactions were undertaken with counterparties with appropriate credit risk;
- Derivatives are subject to appropriate timely measurement, and reporting of risk exposure, independent of the dealer;
- Counterparty confirmations have been sent;
- Incoming confirmations from counterparties have been properly matched and reconciled;
- Early termination and extension of derivatives are subject to the same controls as new derivative transactions;
- Designations, including any subsequent changes in designations, as hedging or speculative transactions, are properly authorized;
- Transactions have been properly recorded and are entered completely and accurately in the accounting records, and correctly processed in any subsidiary ledger through to the financial statements; and
- Adequate security has been maintained over passwords necessary for electronic fund transfers.

65. Examples of tests of controls to consider include:

- Reading minutes of meetings of those charged with governance of the entity (or, where the entity has established one, the Asset/Liability Risk Management Committee or similar group) for evidence of that body's periodic review of derivative activities, adherence to established policies, and periodic review of hedging effectiveness;
- Comparing derivative transactions, including those that have been settled to the entity's policies to determine whether the entity is following those policies. For example, the auditor might:
 - Test that transactions have been executed in accordance with authorizations specified in the entity's policy;
 - Test that any pre-acquisition sensitivity analysis dictated by the investment policy is being performed;
 - Test transactions to determine whether the entity obtained required approvals for the transactions and used only authorized brokers or counterparties;
 - Inquire of management about whether derivatives and related transactions are being monitored and reported upon on a timely basis and read any supporting documentation;
 - Test recorded purchases of derivatives, including their classification and prices, and the entries used to record related amounts;

- Test the reconciliation process. The auditor might test whether reconciling differences are investigated and resolved on a timely basis, and whether the reconciliations are reviewed and approved by supervisory personnel. For example, organizations that have a large number of derivative transactions may require reconciliation and review on a daily basis;
- Test the controls for unrecorded transactions. The auditor might examine the entity's third-party confirmations and the resolution of any exceptions contained in the confirmations;
- Test the controls over the adequate security and back-up of data to ensure adequate recovery in case of disaster. In addition, the auditor may consider the procedures the entity adopts for annual testing and maintenance of the computerized records site.

Substantive Procedures

66. ISA 400 requires the auditor to consider the assessed levels of inherent and control risk in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level. The higher the assessment of inherent and control risk, the more audit evidence the auditor obtains from the performance of substantive procedures.
67. The assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. The auditor performs some substantive procedures for material account balances and classes of transactions. Nevertheless, the auditor may not be able to obtain sufficient appropriate audit evidence to reduce detection risk, and therefore reduce audit risk to an acceptably low level by performing substantive tests alone. If the auditor is unable to reduce audit risk to an acceptably low level, ISA 700, "The Auditor's Report on Financial Statements" requires the auditor to qualify or disclaim an opinion. Furthermore, ISA 400 requires the auditor to make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems that have come to the auditor's attention.

Materiality

68. ISA 320, "Audit Materiality," states that the auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. The auditor's judgment may include assessments of what constitutes materiality for significant captions in the balance sheet, income statement, and statement of cash flows both individually, and for the financial statements as a whole.
69. ISA 320 requires the auditor to consider materiality when determining the nature, timing and extent of audit procedures. While planning the audit,

materiality may be difficult to assess in relation to derivative transactions, particularly given some of their characteristics. Materiality cannot be based on balance sheet values alone, as derivatives may have little effect on the balance sheet, even though significant risks may arise from them. When assessing materiality, the auditor also may consider the potential effect on the account balance or class of transactions on the financial statements. A highly leveraged, or a more complex, derivative may be more likely to have a significant effect on the financial statements than a less highly leveraged or simpler derivative might. Greater potential for effect on the financial statements also exists when the exposure limits for entering into derivative transactions are high.

Types of Substantive Procedures

70. Substantive audit procedures are performed to obtain audit evidence to detect material misstatements in the financial statements, and are of two types: (a) tests of details of transactions and balances; and (b) analytical procedures.
71. In designing substantive tests, the auditor considers:
 - *Appropriateness of accounting.* A primary audit objective often addressed through substantive procedures is determining the appropriateness of an entity's accounting for derivatives;
 - *Involvement of an outside organization.* When planning the substantive procedures for derivatives, the auditor considers whether another organization holds, services or both holds and services the entity's derivatives;
 - *Interim audit procedures.* When performing substantive procedures before the balance sheet date, the auditor considers market movement in the period between the interim testing date and year-end. The value of some derivatives can fluctuate greatly in a relatively short period. As the amount, relative significance, or composition of an account balance becomes less predictable, the value of testing at an interim date becomes less valuable;
 - *Routine vs. non-routine transactions.* Many financial transactions are negotiated contracts between an entity and its counterparty. To the extent that derivative transactions are not routine and outside an entity's normal activities, a substantive audit approach may be the most effective means of achieving the planned audit objectives;
 - *Procedures performed in other audit areas.* Procedures performed in other financial statement areas may provide evidence about the completeness of derivative transactions. These procedures may include tests of subsequent cash receipts and payments, and the search for unrecorded liabilities.

Analytical Procedures

72. ISA 520, “Analytical Procedures,” requires the auditor to apply analytical procedures at the planning and overall review stages of the audit. Analytical procedures also may be applied at other stages of the audit. Analytical procedures as a substantive procedure in the audit of derivative activities may give information about an entity’s business but, by themselves, are generally unlikely to provide sufficient evidence with respect to assertions related to derivatives. The complex interplay of the factors from which the values of these instruments are derived often masks any unusual trends that might arise.
73. Some personnel responsible for derivative activities compile detailed analytical reviews of the results of all derivatives activity. They are able to capture the effect of derivatives trading volumes and market price movements on the financial results of the entity and compile such an analysis because of their detailed day-to-day involvement in the activities. Similarly, some entities may use analytical techniques in their reporting and monitoring activities. Where such analysis is available, the auditor may use it to further understand the entity’s derivative activity. In doing so, the auditor seeks satisfaction that the information is reliable and has been correctly extracted from the underlying accounting records by persons sufficiently objective to be confident that the information fairly reflects the entity’s operations. When appropriate, the auditor may use computer software for facilitating analytical procedures.
74. Analytical procedures may be useful in evaluating certain risk management policies over derivatives, for example, credit limits. Analytical procedures also may be useful in evaluating the effectiveness of hedging activities. For example, if an entity uses derivatives in a hedging strategy, and large gains or losses are noted as a result of analytical procedures, the effectiveness of the hedge may become questionable and accounting for the transaction as a hedge may not be appropriate.
75. Where no such analysis is compiled and the auditor wants to do one, the effectiveness of the analytical review often depends upon the degree to which management can provide detailed and disaggregated information about the activities undertaken. Where such information is available, the auditor may be able to undertake a useful analytical review. If the information is not available, analytical procedures will be effective only as a means of identifying financial trends and relationships in simple, low volume environments. This is because, as volume and complexity of operations increase, unless detailed information is available, the factors affecting revenues and costs are such that meaningful analysis by the auditor often proves difficult, and the value of analytical procedures as an audit tool decreases. In such situations, analytical procedures are not likely to identify inappropriate accounting treatments.

Evaluating Audit Evidence

76. Evaluating audit evidence for assertions about derivatives requires considerable judgment because the assertions, especially those about valuation, are based on highly subjective assumptions or are particularly sensitive to changes in the underlying assumptions. For example, valuation assertions may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or about conditions expected to exist a long time. Accordingly, competent persons could reach different conclusions about estimates of fair values or estimates of ranges of fair values. Considerable judgment also may be required in evaluating audit evidence for assertions based on features of the derivative and applicable accounting principles, including underlying criteria, that are both extremely complex. ISA 540, "Audit of Accounting Estimates," provides guidance to the auditor on obtaining and evaluating sufficient competent audit evidence to support significant accounting estimates. ISA 620 provides guidance on the use of the work of an expert in performing substantive tests.

Substantive Procedures Related to Assertions*Existence and Occurrence*

77. Substantive tests for existence and occurrence assertions about derivatives may include:
- Confirmation with the holder of or the counterparty to the derivative;
 - Inspecting the underlying agreements and other forms of supporting documentation, including confirmations received by an entity, in paper or electronic form, for amounts reported;
 - Inspecting supporting documentation for subsequent realization or settlement after the end of the reporting period;
 - Inquiry and observation.

Rights and Obligations

78. Substantive tests for rights and obligations assertions about derivatives may include:
- Confirming significant terms with the holder of, or counterparty to, the derivative; and
 - Inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form.

Completeness

79. Substantive tests for completeness assertions about derivatives may include:

- Asking the holder of or counterparty to the derivative to provide details of all derivatives and transactions with the entity. In sending confirmations requests, the auditor determines which part of the counterparty's organization is responding, and whether the respondent is responding on behalf of all aspects of its operations;
- Sending zero-balance confirmations to potential holders or counterparties to derivatives to test the completeness of derivatives recorded in the financial records;
- Reviewing brokers' statements for the existence of derivative transactions and positions held;
- Reviewing counterparty confirmations received but not matched to transaction records;
- Reviewing unresolved reconciliation items;
- Inspecting agreements, such as loan or equity agreements or sales contracts, for embedded derivatives. (the accounting treatment of such embedded derivatives may differ among financial reporting frameworks);
- Inspecting documentation for activity subsequent to the end of the reporting period;
- Inquiry and observation; and
- Reading other information, such as minutes of those charged with governance, and related papers and reports on derivative activities received by the governance body.

Valuation and Measurement

80. Tests of valuation assertions are designed according to the valuation method used for the measurement or disclosure. The financial reporting framework may require that a financial instrument be valued based on cost, the amount due under a contract, or fair value. It also may require disclosures about the value of a derivative and specify that impairment losses be recognized in net profit or loss before their realization. Substantive procedures to obtain evidence about the valuation of derivative financial instruments may include:
- Inspecting of documentation of the purchase price;
 - Confirming with the holder of or counterparty to the derivative;
 - Reviewing the creditworthiness of counterparties to the derivative transaction; and
 - Obtaining evidence corroborating the fair value of derivatives measured or disclosed at fair value.
81. The auditor obtains evidence corroborating the fair value of derivatives measured or disclosed at fair value. The method for determining fair value

may vary depending on the industry in which the entity operates, including any specific financial reporting framework that may be in effect for that industry, or the nature of the entity. Such differences may relate to the consideration of price quotations from inactive markets and significant liquidity discounts, control premiums, and commissions and other costs that would be incurred when disposing of a derivative. The method for determining fair value also may vary depending on the type of asset or liability. ISA 540 provides guidance on the audit of accounting estimates contained in financial statements.

82. Quoted market prices for certain derivatives that are listed on exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges or pricing services based on sources such as these. Quoted market prices for other derivatives may be obtained from broker-dealers who are market makers in those instruments. If quoted market prices are not available for a derivative, estimates of fair value may be obtained from third-party sources based on proprietary models or from an entity's internally developed or acquired models. If information about the fair value is provided by a counterparty to the derivative, the auditor considers whether such information is objective. In some instances, it may be necessary to obtain fair value estimates from additional independent sources.
83. Quoted market prices obtained from publications or from exchanges are generally considered to provide sufficient evidence of the value of derivative financial instruments. Nevertheless, using a price quote to test valuation assertions may require a special understanding of the circumstances in which the quote was developed. For example, quotations provided by the counterparty to an option to enter into a derivative financial instrument may not be based on recent trades and may be only an indication of interest. In some situations, the auditor may determine that it is necessary to obtain fair value estimates from broker-dealers or other third-party sources. The auditor also may determine that it is necessary to obtain estimates from more than one pricing source. This may be appropriate if the pricing source has a relationship with an entity that might impair its objectivity.
84. It is management's responsibility to estimate the value of the derivative instrument. If an entity values the derivative using a valuation model, the auditor does not function as an appraiser and the auditor's judgment is not substituted for that of the entity's management. The auditor may test assertions about the fair value determined using a model by procedures such as:
 - Assessing the reasonableness and appropriateness of the model. The auditor determines whether the market variables and assumptions used are reasonable and appropriately supported. Furthermore, the auditor assesses whether market variables and assumptions are used consistently, and whether new conditions justify a change in the market variables or assumptions used. The evaluation of the appropriateness of valuation models and each of the variables and assumptions used in the models may

require considerable judgment and knowledge of valuation techniques, market factors that affect value, and market conditions, particularly in relation to similar financial instruments. Accordingly, the auditor may consider it necessary to involve a specialist in assessing the model;

- Calculating the value, for example, using a model developed by the auditor or by a specialist engaged by the auditor. The re-performance of valuations using the auditor's own models and data enables the auditor to develop an independent expectation to use in corroborating the reasonableness of the value calculated by the entity;
 - Comparing the fair value with recent transactions;
 - Considering the sensitivity of the valuation to changes in the variables and assumptions, including market conditions that may affect the value; and
 - Inspecting supporting documentation for subsequent realization or settlement of the derivative transaction after the end of the reporting period to obtain further evidence about its valuation at the balance sheet date.
85. Some financial reporting frameworks, for example IAS 39, presume that fair value can be reliably determined for most financial assets, including derivatives. That presumption can be overcome for an investment in an equity instrument (including an investment that is in substance an equity instrument) that does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. The presumption can also be overcome for a derivative that is linked to and that must be settled by delivery of such an unquoted equity instrument. Derivatives, for which the presumption that the fair value of the derivative can be reliably determined has been overcome, and that have a fixed maturity, are measured at amortized cost using the effective interest rate method. Those that do not have a fixed maturity are measured at cost.
86. The auditor gathers audit evidence to determine whether the presumption that the fair value of the derivative can be reliably determined has been overcome, and whether the derivative is properly accounted for under the financial reporting framework. If management cannot support that it has overcome the presumption that the fair value of the derivative can be reliably determined, ISA 700 requires that the auditor express a qualified opinion or an adverse opinion. If the auditor is unable to obtain sufficient audit evidence to determine whether the presumption has been overcome, there is a limitation on the scope of the auditor's work. In this case, ISA 700 requires that the auditor express a qualified opinion or a disclaimer of opinion.

Presentation and Disclosure

87. Management is responsible for preparing and presenting the financial statements in accordance with the financial reporting framework, including

fairly and completely presenting and disclosing the results of derivative transactions and relevant accounting policies.

88. The auditor assesses whether the presentation and disclosure of derivatives is in conformity with the financial reporting framework. The auditor's conclusion as to whether derivatives are presented in conformity with the financial reporting framework is based on the auditor's judgment as to whether:
 - The accounting principles selected and applied are in conformity with the financial reporting framework;
 - The accounting principles are appropriate in the circumstances;
 - The financial statements, including the related notes, provide information on matters that may affect their use, understanding, and interpretation;
 - Disclosure is adequate to ensure that the entity is in full compliance with the current disclosure requirements of the financial reporting framework under which the financial statements are being reported, for example, IAS 39;
 - The information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed; and
 - The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.
89. The financial reporting framework may prescribe presentation and disclosure requirements for derivative instruments. For example, some financial reporting frameworks may require users of derivative financial instruments to provide extensive disclosure of the market risk management policies, market risk measurement methodologies and market price information. Other frameworks may not require disclosure of this information as part of the financial statements, but encourage entities to disclose such information outside of the financial statements. ISA 720, "Other Information in Documents Containing Audited Financial Statements," provides guidance on the consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

Additional Considerations about Hedging Activities

90. To account for a derivative transaction as a hedge, some financial reporting frameworks, for example, IAS 39, require that management, at the inception of the transaction, designate the derivative instrument as a hedge and contemporaneously formally document: (a) the hedging relationship, (b) the entity's risk management objective and strategy for undertaking the hedge, and (c) how the entity will assess the hedging instrument's effectiveness in

offsetting the exposure to changes in the hedged item's fair value or the hedged transaction's cash flow that is attributable to the hedged risk. IAS 39 also requires that management have an expectation that the hedge will be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.

91. The auditor gathers audit evidence to determine whether management complied with the applicable hedge accounting requirements of the financial reporting framework, including designation and documentation requirements. In addition, the auditor gathers audit evidence to support management's expectation, both at the inception of the hedge transaction, and on an ongoing basis, that the hedging relationship will be highly effective. If management has not prepared the documentation required by the financial reporting framework, the financial statements may not be in conformity with the applicable financial reporting framework, and ISA 700 would require the auditor to express a qualified opinion or an adverse opinion. Regardless of the financial reporting framework, the auditor is required to obtain sufficient appropriate audit evidence. Therefore, the auditor may obtain documentation prepared by the entity that may be similar to that described in paragraph 90, and may consider obtaining management representations regarding the entity's use and effectiveness of hedge accounting. The nature and extent of the documentation prepared by the entity will vary depending on the nature of the hedged items and the hedging instruments. If sufficient audit evidence to support management's use of hedge accounting is not available, the auditor may have a scope limitation, and may be required by ISA 700 to issue a qualified or disclaimer of opinion.

Management Representations

92. ISA 580, "Management Representations," requires the auditor to obtain appropriate representations from management, including written representations on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. Although management representation letters ordinarily are signed by personnel with primary responsibility for the entity and its financial aspects (ordinarily the senior executive officer and the senior financial officer), the auditor may wish to obtain representations about derivative activities from those responsible for derivative activities within the entity. Depending on the volume and complexity of derivative activities, management representations about derivative financial instruments may include representations about:
 - Management's objectives with respect to derivative financial instruments, for example, whether derivatives are used for hedging or speculative purposes;
 - The financial statement assertions concerning derivative financial instruments, for example:

- The records reflect all derivative transactions;
 - All embedded derivative instruments have been identified;
 - the assumptions and methodologies used in the derivative valuation models are reasonable;
 - Whether all transactions have been conducted at arm's length and at fair market value;
 - The terms of derivative transactions;
 - Whether there are any side agreements associated with any derivative instruments;
 - Whether the entity has entered into any written options; and
 - Whether the entity complies with the documentation requirements of the financial reporting framework for derivatives that are conditions precedent to specified hedge accounting treatments.
93. Sometimes, with respect to certain aspects of derivatives, management representations may be the only audit evidence that reasonably can be expected to be available; however, ISA 580 states that representations from management cannot be a substitute for other audit evidence that the auditor also expects to be available. If the audit evidence the auditor expects to be available cannot be obtained, this may constitute a limitation on the scope of the audit and the auditor considers the implications for the audit report. In this case, ISA 700 requires that the auditor express a qualified opinion or a disclaimer of opinion.

Communications with Management and Those Charged with Governance

94. As a result of obtaining an understanding of an entity's accounting and internal control systems and, if applicable, tests of controls, the auditor may become aware of matters to be communicated to management or those charged with governance. ISA 400 requires that the auditor make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems that have come to the auditor's attention. ISA 260, "Communication of Audit Matters with Those Charged with Governance," requires the auditor to consider audit matters of governance interest that arise from the audit of financial statements and communicate them on a timely basis to those charged with governance. With respect to derivatives, those matters may include:
- Material weaknesses in the design or operation of the accounting and internal control systems;
 - A lack of management understanding of the nature or extent of the derivative activities or the risks associated with such activities;

- A lack of a comprehensive policy on strategy and objectives for using derivatives, including operational controls, definition of “effectiveness” for derivatives designated as hedges, monitoring exposures and financial reporting; or
- A lack of segregation of duties.

Glossary of Terms

Asset/Liability Management—A planning and control process, the key concept of which is matching the mix and maturities of assets and liabilities.

Basis—The difference between the price of the hedged item and the price of the related hedging instrument.

Basis Risk—The risk that the basis will change while the hedging contract is open and, thus, the price correlation between the hedged item and hedging instrument will not be perfect.

Cap—A series of call options based on a notional amount. The strike price of these options defines an upper limit to interest rates.

Close Out—The consummation or settlement of a financial transaction.

Collateral—Assets pledged by a borrower to secure a loan or other credit; these are subject to seizure in the event of default.

Commodity—A physical substance, such as food, grains and metals that is interchangeable with other product of the same type.

Correlation—The degree to which contract prices of hedging instruments reflect price movements in the cash-market position. The correlation factor represents the potential effectiveness of hedging a cash-market instrument with a contract where the deliverable financial instrument differs from the cash-market instrument. Generally, the correlation factor is determined by regression analysis or some other method of technical analysis of market behavior.

Counterparty—The other party to a derivative transaction.

Credit Risk—The risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter.

Dealer (for the purposes of this IAPS)—The person who commits the entity to a derivative transaction.

Derivative—A generic term used to categorize a wide variety of financial instruments whose value “depends on” or is “derived from” an underlying rate or price, such as interest rates, exchange rates, equity prices, or commodity prices. Many national financial reporting frameworks, and the International Accounting Standards contain definitions of derivatives. For example, International Accounting Standard (IAS) 39,

“Financial Instruments: Recognition and Measurement,” defines a derivative as a financial instrument:

- whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the “underlying”);
- that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
- that is settled at a future date.

Embedded Derivative Instruments—Implicit or explicit terms in a contract or agreement that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative.

End User—An entity that enters into a financial transaction, either through an organized exchange or a broker, for the purpose of hedging, asset/liability management or speculating. End users consist primarily of corporations, government entities, institutional investors and financial institutions. The derivative activities of end users are often related the production or use of a commodity by the entity.

Exchange-Traded Derivatives—Derivatives traded under uniform rules through an organized exchange.

Fair Value—The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.

Floor—A series of put options based on a notional amount. The strike price of these options defines a lower limit to the interest rate.

Foreign Exchange Contracts—Contracts that provide an option for, or require a future exchange of foreign currency assets or liabilities.

Foreign Exchange Risk—The risk of losses arising through repricing of foreign currency instruments because of exchange rate fluctuations.

Forward Contracts—A contract negotiated between two parties to purchase and sell a specified quantity of a financial instrument, foreign currency, or commodity at a price specified at the origination of the contract, with delivery and settlement at a specified future date.

Forward Rate Agreements—An agreement between two parties to exchange an amount determined by an interest rate differential at a given future date based on the difference

between an agreed interest rate and a reference rate (LIBOR, Treasury bills, etc.) on a notional principal amount.

Futures Contracts—Exchange-traded contracts to buy or sell a specified financial instrument, foreign currency or commodity at a specified future date or during a specified period at a specified price or yield.

Hedge—A strategy that protects an entity against the risk of adverse price or interest-rate movements on certain of its assets, liabilities or anticipated transactions. A hedge is used to avoid or reduce risks by creating a relationship by which losses on certain positions are expected to be counterbalanced in whole or in part by gains on separate positions in another market.

Hedging, (for accounting purposes)—Designating one or more hedging instruments so that their change in fair value is an offset, completely or in part, to the change in fair value or cash flows of a hedged item.

Hedged Item—An asset, liability, firm commitment, or forecasted future transaction that (a) exposes an entity to risk of changes in fair value or changes in future cash flows and (b) for hedge accounting purposes, is designated as being hedged.

Hedging Instrument, (for hedge accounting purposes)—A designated derivative or (in limited circumstances) another financial asset or liability whose value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

Hedge Effectiveness—The degree to which offsetting changes in fair value or cash flows attributable to a hedged risk are achieved by the hedging instrument.

Interest Rate Risk—The risk that a movement in interest rates would have an adverse effect on the value of assets and liabilities or would affect interest cash flows.

Interest Rate Swap—A contract between two parties to exchange periodic interest payments on a notional amount (referred to as the notional principal) for a specified period. In the most common instance, an interest rate swap involves the exchange of streams of variable and fixed-rate interest payments.

Legal Risk—The risk that a legal or regulatory action could invalidate or otherwise preclude performance by the end user or its counterparty under the terms of the contract.

LIBOR (London Interbank Offered Rate)—An international interest rate benchmark. It is commonly used as a repricing benchmark for financial instruments such as adjustable rate mortgages, collateralized mortgage obligations and interest rate swaps.

Linear Contracts—Contracts that involve obligatory cash flows at a future date.

Liquidity—The capability of a financial instrument to be readily convertible into cash.

Liquidity Risk—Changes in the ability to sell or dispose of the derivative. Derivatives bear the additional risk that a lack of sufficient contracts or willing counterparties may make it difficult to close out the derivative or enter into an offsetting contract.

Margin—(1) The amount of deposit money a securities broker requires from an investor to purchase securities on behalf of the investor on credit. (2) An amount of money or securities deposited by both buyers and sellers of futures contracts and short options to ensure performance of the terms of the contract, i.e., the delivery or taking of delivery of the commodity, or the cancellation of the position by a subsequent offsetting trade. Margin in commodities is not a payment of equity or down payment on the commodity itself, but rather a performance bond or security deposit.

Margin Call—A call from a broker to a customer (called a maintenance margin call) or from a clearinghouse to a clearing member (called a variation margin call) demanding the deposit of cash or marketable securities to maintain a requirement for the purchase or short sale of securities or to cover an adverse price movement.

Market Risk—The risk of losses arising because of adverse changes in the value of derivatives due to changes in equity prices, interest rates, foreign exchange rates, commodity prices or other market factors. Interest rate risk and foreign exchange risk are sub-sets of market risk.

Model Risk—The risk associated with the imperfections and subjectivity of valuation models used to determine the fair value of a derivative.

Non-Linear Contracts—Contracts that have option features where one party has the right, but not the obligation to demand that another party deliver the underlying item to it.

Notional Amount—A number of currency units, shares, bushels, pounds or other units specified in a derivative instrument.

Off-Balance-Sheet Instrument—A derivative financial instrument that is not recorded on the balance sheet, although it may be disclosed.

Off-Balance-Sheet Risk—The risk of loss to the entity in excess of the amount, if any, of the asset or liability that is recognized on the balance sheet.

Option—A contract that gives the holder (or purchaser) the right, but not the obligation to buy (call) or sell (put) a specific or standard commodity, or financial instrument, at a specified price during a specified period (the American option) or at a specified date (the European option).

Policy—Management's dictate of what should be done to effect control. A policy serves as the basis for procedures and their implementation.

Position—The status of the net of claims and obligations in financial instruments of an entity.

Price Risk—The risk of changes in the level of prices due to changes in interest rates, foreign exchange rates or other factors that relate to market volatility of the underlying rate, index or price.

Risk Management—Using derivatives and other financial instruments to increase or decrease risks associated with existing or anticipated transactions.

Sensitivity Analysis—A general class of models designed to assess the risk of loss in market-risk-sensitive instruments based upon hypothetical changes in market rates or prices.

Settlement Date—The date on which derivative transactions are to be settled by delivery or receipt of the underlying product or instrument in return for payment of cash.

Settlement Risk—The risk that one side of a transaction will be settled without value being received from the counterparty.

Solvency Risk—The risk that an entity would not have funds available to honor cash outflow commitments as they fall due.

Speculation—Entering into an exposed position to maximize profits, that is, assuming risk in exchange for the opportunity to profit on anticipate market movements.

Swaption—A combination of a swap and an option.

Term Structure of Interest Rates—The relationship between interest rates of different terms. When interest rates of bonds are plotted graphically according to their interest rate terms, this is called the "yield curve." Economists and investors believe that the shape of the yield curve reflects the market's future expectation for interest rates and thereby provide predictive information concerning the conditions for monetary policy.

Trading—The buying and selling of financial instruments for short-term profit.

Underlying—A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability, but it is not the asset or liability itself.

Valuation Risk—The risk that the fair value of the derivative is determined incorrectly.

Value at Risk—A general class of models that provides a probabilistic assessment of the risk of loss in market-risk-sensitive instruments over a period of time, with a selected likelihood of occurrences based upon selected confidence intervals.

Volatility—A measure of the variability of the price of an asset or index.

Written Option—The writing, or sale, of an option contract that obligates the writer to fulfill the contract should the holder choose to exercise the option.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1013

ELECTRONIC COMMERCE—EFFECT ON THE AUDIT OF FINANCIAL STATEMENTS

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International Auditing Practice Statements (“Statements”) are issued by the International Auditing Practices Committee (“IAPC”) of the International Federation of Accountants to provide practical assistance to auditors in implementing the International Standards on Auditing (“ISAs”) or to promote good practice. Statements do not have the authority of ISAs.

This Statement does not establish any new basic principles or essential procedures: its purpose is to assist auditors of financial statements, and promote good practice, by providing:

- (a) Guidance on the application of the ISAs where an entity uses a public network, such as the Internet, for electronic commerce, and
- (b) Material to enhance awareness of financial statements audit issues in this rapidly developing area.

The auditor exercises professional judgment to determine the extent to which any of the audit procedures described in this Statement may be appropriate in the light of the requirements of the ISAs and the entity’s particular circumstances.

This Statement was approved by the IAPC for publication in March 2002.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where no PSP is added, the IAPS is applicable in all material respects to the public sector.

Introduction

1. The purpose of this International Auditing Practice Statement is to provide guidance to assist auditors of financial statements where an entity engages in commercial activity that takes place by means of connected computers over a public network, such as the Internet (e-commerce¹). The guidance in this Statement is particularly relevant to the application of ISA 300, "Planning," ISA 310, "Knowledge of the Business" and ISA 400, "Risk Assessments and Internal Control."
2. This Statement identifies specific matters to assist the auditor when considering the significance of e-commerce to the entity's business activities and the effect of e-commerce on the auditors assessments of risk for the purpose of forming an opinion on the financial statements. The purpose of the auditor's consideration is not to form an opinion or provide consulting advice concerning the entity's e-commerce systems or activities in their own right.
3. Communications and transactions over networks and through computers are not new features of the business environment. For example, business processes frequently involve interaction with a remote computer, the use of computer networks, or electronic data interchange (EDI). However the increasing use of the Internet for business to consumer, business to business, business to government and business to employee e-commerce is introducing new elements of risk to be addressed by the entity and considered by the auditor when planning and performing the audit of the financial statements.
4. The Internet refers to the worldwide network of computer networks, it is a shared public network that enables communication with other entities and individuals around the world. It is interoperable, which means that any computer connected to the Internet can communicate with any other computer connected to the Internet. The Internet is a public network, in contrast to a private network that only allows access to authorized persons or entities. The use of a public network introduces special risks to be addressed by the entity. Growth of Internet activity without due attention by the entity to those risks may affect the auditor's assessment of risk.
5. While this Statement has been written for situations where the entity engages in commercial activity over a public network such as the Internet, much of the guidance it contains can also be applied when the entity uses a private network. Similarly, while much of this guidance will be helpful when auditing entities formed primarily for e-commerce activities (often called "dot coms") it is not intended to deal with all audit issues that would be addressed in the audit of such entities.

¹ The term e-commerce is used in this IAPS. E-business is also commonly used in a similar context. There are no generally accepted definitions of these terms, and e-commerce and e-business are often used interchangeably. Where a distinction is made, e-commerce is sometimes used to refer solely to transactional activities (such as the buying and selling of goods and services) and e-business is used to refer to all business activities, both transactional and non-transactional, such as customer relations and communications.

Skills and Knowledge

6. The level of skills and knowledge required to understand the effect of e-commerce on the audit will vary with the complexity of the entity's e-commerce activities. The auditor considers whether the personnel assigned to the engagement have appropriate IT² and Internet business knowledge to perform the audit. When e-commerce has a significant effect on the entity's business, appropriate levels of both information technology (IT) and Internet business knowledge may be required to:
 - Understand, so far as they may affect the financial statements:
 - The entity's e-commerce strategy and activities;
 - The technology used to facilitate the entity's e-commerce activities and the IT skills and knowledge of entity personnel;
 - The risks involved in the entity's use of e-commerce and the entity's approach to managing those risks, particularly the adequacy of the internal control system, including the security infrastructure and related controls, as it affects the financial reporting process;
 - Determine the nature, timing and extent of audit procedures and evaluate audit evidence;
 - Consider the effect of the entity's dependence on e-commerce activities on its ability to continue as a going concern.
7. In some circumstances, the auditor may decide to use the work of an expert, for example if the auditor considers it appropriate to test controls by attempting to break through the security layers of the entity's system (vulnerability or penetration testing). When the work of an expert is used, the auditor obtains sufficient appropriate audit evidence that such work is adequate for the purposes of the audit, in accordance with ISA 620, "Using the Work of an Expert." The auditor also considers how the work of the expert is integrated with the work of others on the audit, and what procedures are undertaken regarding risks identified through the expert's work.

Knowledge of the Business

8. ISA 310, "Knowledge of the Business" requires that the auditor obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that may have a significant effect on the financial statements or on the audit report. Knowledge of the business includes a general knowledge of the economy and the industry within

² International Education Guideline IEG 11, "Information Technology in the Accounting Curriculum" issued by the Education Committee of IFAC, which defines the broad content areas and specific skills and knowledge required by all professional accountants in connection with IT applied in a business context, may assist the auditor in identifying appropriate skills and knowledge.

which the entity operates. The growth of e-commerce may have a significant effect on the entity's traditional business environment.

9. The auditor's knowledge of the business is fundamental to assessing the significance of e-commerce to the entity's business activities and any effect on audit risk. The auditor considers changes in the entity's business environment attributable to e-commerce, and e-commerce business risks as identified so far as they affect the financial statements. Although the auditor obtains much information from inquiries of those responsible for financial reporting, making inquiries of personnel directly involved with the entity's e-commerce activities, such as the Chief Information Officer or equivalent, may also be useful. In obtaining or updating knowledge of the entity's business, the auditor considers, so far as they affect the financial statements:

- The entity's business activities and industry (paragraphs 10-12);
- The entity's e-commerce strategy (paragraph 13);
- The extent of the entity's e-commerce activities (paragraphs 14-16); and
- The entity's outsourcing arrangements (paragraphs 17-18).

Each of these is discussed below.

The Entity's Business Activities and Industry

10. E-commerce activities may be complementary to an entity's traditional business activity. For example, the entity may use the Internet to sell conventional products (such as books or CDs), delivered by conventional methods from a contract executed on the Internet. In contrast, e-commerce may represent a new line of business and the entity may use its web site to both sell and deliver digital products via the Internet.
11. The Internet lacks the clear, fixed geographic lines of transit that traditionally have characterized the physical trade of many goods and services. In many cases, particularly where goods or services can be delivered via the Internet, e-commerce has been able to reduce or eliminate many of the limitations imposed by time and distance.
12. Certain industries are more conducive to the use of e-commerce, therefore e-commerce in these industries is in a more mature phase of development. When an entity's industry has been significantly influenced by e-commerce over the Internet, business risks that may affect the financial statements may be greater. Examples of industries that are being transformed by e-commerce include:
 - Computer software;
 - Securities trading;
 - Banking;
 - Travel services;

- Books and magazines;
- Recorded music;
- Advertising;
- News media; and
- Education.

In addition many other industries, in all business sectors, have been significantly affected by e-commerce.

The Entity's E-Commerce Strategy

13. The entity's e-commerce strategy, including the way it uses IT for e-commerce and its assessment of acceptable risk levels, may affect the security of the financial records and the completeness and reliability of the financial information produced. Matters that may be relevant to the auditor when considering the entity's e-commerce strategy in the context of the auditor's understanding of the control environment, include:
 - Involvement of those charged with governance in considering the alignment of e-commerce activities with the entity's overall business strategy;
 - Whether e-commerce supports a new activity for the entity, or whether it is intended to make existing activities more efficient or reach new markets for existing activities;
 - Sources of revenue for the entity and how these are changing (for example, whether the entity will be acting as a principal or agent for goods or services sold);
 - Management's evaluation of how e-commerce affects the earnings of the entity and its financial requirements;
 - Management's attitude to risk and how this may affect the risk profile of the entity;
 - The extent to which management has identified e-commerce opportunities and risks in a documented strategy that is supported by appropriate controls, or whether e-commerce is subject to ad hoc development responding to opportunities and risks as they arise; and
 - Management's commitment to relevant codes of best practice or web seal programs.

The Extent of the Entity's E-commerce Activities

14. Different entities use e-commerce in different ways. For example, e-commerce might be used to:

- Provide only information about the entity and its activities, which can be accessed by third parties such as investors, customers, suppliers, finance providers, and employees;
 - Facilitate transactions with established customers whereby transactions are entered via the Internet;
 - Gain access to new markets and new customers by providing information and transaction processing via the Internet;
 - Access Application Service Providers (ASPs); and
 - Create an entirely new business model.
15. The extent of e-commerce use affects the nature of risks to be addressed by the entity. Security issues may arise whenever the entity has a web site. Even if there is no third party interactive access, information-only pages can provide an access point to the entity's financial records. The security infrastructure and related controls can be expected to be more extensive where the web site is used for transacting with business partners, or where systems are highly integrated (see paragraphs 32–34).
16. As an entity becomes more involved with e-commerce, and as its internal systems become more integrated and complex, it becomes more likely that new ways of transacting business will differ from traditional forms of business activity and will introduce new types of risks.

The Entity's Outsourcing Arrangements

17. Many entities do not have the technical expertise to establish and operate in-house systems needed to undertake e-commerce. These entities may depend on service organizations such as Internet Service Providers (ISPs), Application Service Providers (ASPs) and data hosting companies to provide many or all of the IT requirements of e-commerce. The entity may also use service organizations for various other functions in relation to its e-commerce activities such as order fulfillment, delivery of goods, operation of call centers and certain accounting functions.
18. When the entity uses a service organization, certain policies, procedures and records maintained by the service organization may be relevant to the audit of the entity's financial statements. The auditor considers the outsourcing arrangements used by the entity to identify how the entity responds to risks arising from the outsourced activities. ISA 402, "Audit Considerations Relating to Entities Using Service Organizations" provides guidance on assessing the effect that the service entity has on control risk.

Risk Identification

19. Management faces many business risks relating to the entity's e-commerce activities, including:

- Loss of transaction integrity, the effects of which may be compounded by the lack of an adequate audit trail in either paper or electronic form;
 - Pervasive e-commerce security risks, including virus attacks and the potential for the entity to suffer fraud by customers, employees and others through unauthorized access;
 - Improper accounting policies related to, for example, capitalization of expenditures such as website development costs, misunderstanding of complex contractual arrangements, title transfer risks, translation of foreign currencies, allowances for warranties or returns, and revenue recognition issues such as:
 - Whether the entity is acting as principal or agent and whether gross sales or commission only are to be recognized;
 - If other entities are given advertising space on the entity's web site, how revenues are determined and settled (for example, by the use of barter transactions);
 - The treatment of volume discounts and introductory offers (for example, free goods worth a certain amount);
 - Cut off (for example, whether sales are only recognized when goods and services have been supplied);
 - Noncompliance with taxation and other legal and regulatory requirements, particularly when Internet e-commerce transactions are conducted across international boundaries;
 - Failure to ensure that contracts evidenced only by electronic means are binding;
 - Over reliance on e-commerce when placing significant business systems or other business transactions on the Internet; and
 - Systems and infrastructure failures or "crashes".
20. The entity addresses certain business risks arising in e-commerce through the implementation of an appropriate security infrastructure and related controls, which generally include measures to:
- Verify the identity of customers and suppliers;
 - Ensure the integrity of transactions;
 - Obtain agreement on terms of trade, including agreement of delivery and credit terms and dispute resolution processes, which may address tracking of transactions and procedures to ensure a party to a transaction cannot later deny having agreed to specified terms (non-repudiation procedures);
 - Obtain payment from, or secure credit facilities for, customers; and
 - Establish privacy and information protection protocols.

21. The auditor uses the knowledge of the business obtained to identify those events, transactions and practices related to business risks arising from the entity's e-commerce activities that, in the auditor's judgment, may result in a material misstatement of the financial statements or have a significant effect on the auditor's procedures or the audit report.

Legal and Regulatory Issues

22. A comprehensive international legal framework for e-commerce and an efficient infrastructure to support such a framework (electronic signatures, document registries, dispute mechanisms, consumer protection etc) does not yet exist. Legal frameworks in different jurisdictions vary in their recognition of e-commerce. Nonetheless, management needs to consider legal and regulatory issues related to the entity's e-commerce activities, for example, whether the entity has adequate mechanisms for recognition of taxation liabilities, particularly sales or value-added taxes, in various jurisdictions. Factors that may give rise to taxes on e-commerce transactions include the place where:

- The entity is legally registered;
- Its physical operations are based;
- Its web server is located;
- Goods and services are supplied from; and
- Its customers are located or goods and services are delivered.

These may all be in different jurisdictions. This may give rise to a risk that taxes due on cross-jurisdictional transactions are not appropriately recognized.

23. Legal or regulatory issues that may be particularly relevant in an e-commerce environment include:
 - Adherence to national and international privacy requirements;
 - Adherence to national and international requirements for regulated industries;
 - The enforceability of contracts;
 - The legality of particular activities, for example Internet gambling;
 - The risk of money laundering; and
 - Violation of intellectual property rights.
24. ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" requires that when planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. ISA 250 also requires that, in order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory

framework applicable to the entity and the industry and how the entity is complying with that framework. That framework may, in the particular circumstances of the entity, include certain legal and regulatory issues related to its e-commerce activities. While ISA 250 recognizes that an audit cannot be expected to detect noncompliance with all laws and regulations, the auditor is specifically required to perform procedures to help identify instances of noncompliance with those laws and regulations where noncompliance should be considered when preparing financial statements. When a legal or regulatory issue arises that, in the auditor's judgment, may result in a material misstatement of the financial statements or have a significant effect on the auditor's procedures or the audit report, the auditor considers management's response to the issue. In some cases, the advice of a lawyer with particular expertise in e-commerce issues may be necessary when considering legal and regulatory issues arising from an entity's e-commerce activity.

Internal Control Considerations

25. Internal controls can be used to mitigate many of the risks associated with e-commerce activities. In accordance with ISA 400, "Risk Assessments and Internal Control," the auditor considers the control environment and control procedures the entity has applied to its e-commerce activities to the extent they are relevant to the financial statement assertions. In some circumstances, for example when electronic commerce systems are highly automated, when transaction volumes are high, or when electronic evidence comprising the audit trail is not retained, the auditor may determine that it is not possible to reduce audit risk to an acceptably low level by using only substantive procedures. CAATs are often used in such circumstances (refer to IAPS 1009, "Computer-Assisted Audit Techniques").
26. As well as addressing security, transaction integrity and process alignment, as discussed below, the following aspects of internal control are particularly relevant when the entity engages in e-commerce:
 - Maintaining the integrity of control procedures in the quickly changing e-commerce environment;
 - Ensuring access to relevant records for the entity's needs and for audit purposes.

Security

27. The entity's security infrastructure and related controls are a particularly important feature of its internal control system when external parties are able to access the entity's information system using a public network such as the Internet. Information is secure to the extent that the requirements for its authorization, authenticity, confidentiality, integrity, non-repudiation and availability have been satisfied.

28. The entity will ordinarily address security risks related to the recording and processing of e-commerce transactions through its security infrastructure and related controls. The security infrastructure and related controls may include an information security policy, an information security risk assessment, and standards, measures, practices, and procedures within which individual systems are introduced and maintained, including both physical measures and logical and other technical safeguards such as user identifiers, passwords and firewalls. To the extent they are relevant to the financial statement assertions the auditor considers such matters as:
- The effective use of firewalls and virus protection software to protect its systems from the introduction of unauthorized or harmful software, data or other material in electronic form,
 - The effective use of encryption, including both:
 - Maintaining the privacy and security of transmissions through, for example, authorization of decryption keys; and
 - Preventing the misuse of encryption technology through, for example, controlling and safeguarding private decryption keys;
 - Controls over the development and implementation of systems used to support e-commerce activities;
 - Whether security controls in place continue to be effective as new technologies that can be used to attack Internet security become available;
 - Whether the control environment supports the control procedures implemented. For example, while some control procedures, such as digital certificate-based encryption systems, can be technically advanced, they may not be effective if they operate within an inadequate control environment.

Transaction Integrity

29. The auditor considers the completeness, accuracy, timeliness and authorization of information provided for recording and processing in the entity's financial records (transaction integrity). The nature and the level of sophistication of an entity's e-commerce activities influence the nature and extent of risks related to the recording and processing of e-commerce transactions.
30. Audit procedures regarding the integrity of information in the accounting system relating to e-commerce transactions are largely concerned with evaluating the reliability of the systems in use for capturing and processing such information. In a sophisticated system, the originating action, for example receipt of a customer order over the Internet, will automatically initiate all other steps in processing the transaction. Therefore, in contrast to audit procedures for traditional business activities, which ordinarily focus separately on control processes relating to each stage of transaction capture and processing, audit procedures for sophisticated e-commerce often focus on

automated controls that relate to the integrity of transactions as they are captured and then immediately and automatically processed.

31. In an e-commerce environment, controls relating to transaction integrity are often designed to, for example:
 - Validate input;
 - Prevent duplication or omission of transactions;
 - Ensure the terms of trade have been agreed before an order is processed, including delivery and credit terms, which may require, for example, that payment is obtained when an order is placed;
 - Distinguish between customer browsing and orders placed, ensure a party to a transaction cannot later deny having agreed to specified terms (non-repudiation), and ensure transactions are with approved parties when appropriate;
 - Prevent incomplete processing by ensuring all steps are completed and recorded (for example, for a business to consumer transaction: order accepted, payment received, goods/services delivered and accounting system updated) or if all steps are not completed and recorded, by rejecting the order;
 - Ensure the proper distribution of transaction details across multiple systems in a network (for example, when data is collected centrally and is communicated to various resource managers to execute the transaction); and
 - Ensure records are properly retained, backed-up and secured.

Process Alignment

32. Process alignment refers to the way various IT systems are integrated with one another and thus operate, in effect, as one system. In the e-commerce environment, it is important that transactions generated from an entity's web site are processed properly by the entity's internal systems, such as the accounting system, customer relationship management systems and inventory management systems (often known as "back office" systems). Many web sites are not automatically integrated with internal systems.
33. The way e-commerce transactions are captured and transferred to the entity's accounting system may affect such matters as:
 - The completeness and accuracy of transaction processing and information storage;
 - The timing of the recognition of sales revenues, purchases and other transactions; and
 - Identification and recording of disputed transactions.

34. When it is relevant to the financial statement assertions, the auditor considers the controls governing the integration of e-commerce transactions with internal systems, and the controls over systems changes and data conversion to automate process alignment.

The Effect of Electronic Records on Audit Evidence

35. There may not be any paper records for e-commerce transactions, and electronic records may be more easily destroyed or altered than paper records without leaving evidence of such destruction or alteration. The auditor considers whether the entity's security of information policies, and security controls as implemented, are adequate to prevent unauthorized changes to the accounting system or records, or to systems that provide data to the accounting system.
36. The auditor may test automated controls, such as record integrity checks, electronic date stamps, digital signatures, and version controls when considering the integrity of electronic evidence. Depending on the auditor's assessment of these controls, the auditor may also consider the need to perform additional procedures such as confirming transaction details or account balances with third parties (refer to ISA 505, "External Confirmations").

DISCUSSION PAPERS

The Committee has issued one discussion paper, as summarized below.

Discussion Paper The Audit Profession and the Environment Issued May 1995

The audit profession can contribute its expertise and services to business and society in making progress towards sustainable development, and towards management of and accountability for environmental stewardship. The profession has the strength, reputation and skills needed to expand its role and contribute to:

- The development of standards and guidance for audit and review of financial statements regarding environmental matters;
- Arrangements necessary for obtaining audit evidence that requires the co-operation or use of the work of other professions and disciplines in areas outside the normal competence of financial auditors; and
- The development of standards and guidance needed to respond to the expectations of stakeholders for emerging new services.

IFAC, in its role of representing the worldwide audit profession, is interested in collaborating with other associations, organizations, professions and disciplines, since sustainable development and environmental issues are inherently multi-disciplinary issues, and no single discipline or profession is likely to provide all the solutions. Some member bodies already have authoritative literature on the subject in place or under development. This document seeks to summarize the topics and promote discussion on an international level. The document does not discuss accounting matters.

The preparation of this discussion paper serves three purposes:

- To generate ideas and views on issues to be dealt with by the auditing profession as a whole with regard to ‘environmental auditing’;
- To gather views of practitioners on the more important implications of environmental issues in relation to the audit of financial statements; and
- To promote discussion amongst both practitioners and a wider audience on reporting on environmental performance, the audit of such reports and on possible future engagements (reporting on, and audits of, environmental management systems and compliance engagements),

To serve these purposes, questions for discussion are included at the end of each chapter. The document is also distributed outside the auditing community.

STUDIES

Study 1

The Determination and Communication of Levels of Assurance Other than High Issued June 2002

This is an extensive study of the determination and communication of levels of assurance other than high. The accurate determination and effective communication of levels of assurance provided in assurance engagements are critical issues for the well-being of the profession and the future development of assurance services. The development stage of new assurance services requires many decisions regarding their design, including how their level of assurance is determined and communicated. These decisions are very important as they will affect the risks and opportunities associated with providing new assurance services. The information contained in this study, which consists of an extensive literature review of related initiatives within and outside the profession, accompanied by two empirical studies, are an important input for decision-making regarding the determination and communication of levels of assurance. This study was conducted by an international network of auditing academics.

The study is available on the website of the IAASB at <http://www.iaasb.org>.

STATEMENT OF POLICY OF COUNCIL*

**RECOGNITION OF PROFESSIONAL
ACCOUNTANCY QUALIFICATIONS**

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* Effective May 2000 the IFAC Council was renamed the IFAC Board.

Introduction

1. The mission of the International Federation of Accountants (IFAC) is the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide services of consistently high quality in the public interest. Inherent in this mission statement is the understanding that services of consistently high quality implies that professional standards governing those services are also of consistently high quality. Consistently high standards will facilitate the international practice of the accountancy profession.
2. Accountants have traditionally practiced internationally, both as individuals and as firms. The main impetus behind this movement has been the globalization of business, which has accelerated especially in recent years. As enterprises became multinational, they asked that their financial advisors be equally multinational. As a result, professional accountants have organized themselves into global organizations, providing a wide range of services throughout the world.
3. Notwithstanding these developments, national professional institutes and national regulatory authorities have been reluctant to accept the professional qualifications of foreign accountants for regulated services. Conditions of residence, citizenship, special educational criteria and examinations have been set, conditions which are, in many cases, impossible to meet. Moreover, some of these criteria do not pertain to the professional qualifications. Given the international scope of the accountancy profession, professionally qualified accountants, both as individuals and firms, are increasingly seeking to be recognized in foreign countries, and often see these barriers as unreasonable.
4. The demand for recognition of foreign accountancy qualifications has been given special impetus by the successful completion of the Uruguay Round of trade negotiations, and the General Agreement on Trade in Services (GATS). The GATS addresses regulatory obstacles to international trade and foreign investment in service industries, including the cross-border practice of accountancy and other professions. It sets out a series of rules to discipline government intervention in the marketplace, to ensure that foreign or internationally-affiliated service providers, firms and professionals enjoy the same privileges as their domestic counterparts or competitors with respect to government regulation and to remove discriminatory obstacles to market entry and practice by persons from other countries. Signatories to the GATS and its provisions bind their national and sub-national regulatory authorities.
5. The Council* of IFAC acknowledges that a truly international market for accountancy services, with equal access to all qualified professionals, is

* Effective May 2000 the IFAC Council was renamed the IFAC Board.

consistent with its mission, and it encourages national professional accountancy organizations and regulatory/licensing authorities to provide for recognition of foreign accountancy qualifications. Of more concern, however, is the public interest, and IFAC believes that any mutual recognition efforts must insure that the overriding need for high standards must be scrupulously respected. In this regard, benchmark international standards, such as those promulgated by IFAC and IASC, can be especially useful in meeting this need.

6. Given the above situation, the Council* of IFAC has issued this Statement of Policy, to be used by its member bodies and other interested parties. The provisions of this Statement of Policy will assist with the implementation of the provisions of GATS, as well as helping to insure that the proper standards of professional qualifications are also maintained.

The Changing Rules of Recognition of Accountancy Qualifications

7. Traditionally, the mutual recognition of qualifications of professional accountants of one jurisdiction in another has been arranged between professional organizations with close relationships and with similar traditions, goals and objectives. Sometimes such recognition has been extended by licensing authorities where permission to undertake audits/attest or other reserved functions has been extended by a licensing authority rather than by a professional body.
8. Generally, the recognition is conditional upon an applicant satisfying some agreed additional education, experience, examination or residence requirements to recognize differences in the jurisdictions concerned. Because of sometimes conflicting economic, social and political factors, such arrangements were not widespread. Diverse requirements for qualification as an accountant, variances in educational systems and differences in accounting and auditing standards and related laws and regulations, as well as differences in the way the profession is regulated in various countries, has tended to inhibit mobility. Additionally, criteria related to citizenship and residency have added further barriers.
9. The new GATS addresses regulatory obstacles to international trade and foreign investment in service industries, including the cross-border practice of accountancy and other professions, by setting out rules that intend to:
 - Ensure that foreign or internationally-affiliated service providers, firms and professionals enjoy the same privileges as their domestic counterparts or competitors with respect to government regulation,
 - Remove discriminatory obstacles to market entry and practice by persons from other countries, by concentrating solely on those issues that relate to professional qualifications, and
 - Provide transparency to all service providers as to the rules governing recognition of qualifications.

- Although they apply to the full range of service industry and professions, two of the GATS rules have particular relevance to the accountancy profession (Article VI on “Domestic Regulation” and Article VII on the “Recognition of Qualifications and Licenses” which are in Appendix 1).
10. In essence, GATS seeks to ensure that persons from one country wishing to provide services in another enjoy the same privileges as their domestic counterparts. Recognition requirements may not constitute unreasonable barriers to trade in services. It is expected that rules will be developed on a sector by sector basis to ensure that licensing requirements are based on objective and transparent criteria and are not more burdensome than is necessary to ensure the quality of the service.
 11. The GATS requires that all countries have adequate procedures in place to verify the qualifications of professionals from other countries seeking the right to offer services within their jurisdictions. This will have implications both for the professional accountancy organizations, as well as for the licensing and regulatory authorities.
 12. Although the GATS is multinational in scope, it does provide for bi-lateral implementation. IFAC believes that the most effective way to achieve recognition is through bi-lateral initiatives. There are differences in educational and examination standards, experience requirements, professional issues, regulatory influence and various other matters, all of which make implementing the recognition on a multilateral basis extremely difficult. Bi-lateral negotiations will enable the countries involved to focus on the key issues related to their two environments. Once bi-lateral agreements have been achieved, however, this can lead to other bi-lateral agreements, which will ultimately extend mutual recognition more broadly.

Principles of Recognition

13. The GATS requires that criteria for recognition of qualifications may not exceed what is necessary to ensure the quality of service. Each country is expected to have a methodology for comparing professional qualifications and this must be applied in a fair and consistent manner to all applicants. IFAC recommends that the appraisal process be founded upon the key components of a professional qualification, falling into the following three areas:
 - Education—entry standards/body of knowledge
 - Examinations—tests of professional competence
 - Experience—relevant to the practice function
14. In implementing the appraisal process, the following principles are suggested. These parallel the recommendations of International Education Guideline 9 (IEG 9) and are put forward because they have been found to

be widely acceptable within the profession in meeting the need to uphold its high standards and protect the public interest. Additionally, they can assist countries that are negotiating mutual recognitions in making informed decisions as to the degree of equivalence in basic educational requirements. This is a crucial procedure, since, when there is sufficient equivalence in the basic education requirements of the two bodies, the negotiating parties can proceed more efficiently.

Education

15. Initially, the subjects and skills covered in their bodies of knowledge should be compared. The theoretical knowledge to be contained in the body of knowledge of persons seeking recognition should include at least the following subjects:
 - Analysis and critical assessment of financial statements;
 - Audit;
 - Consolidated accounts;
 - Cost and management accounting;
 - General accounting;
 - Internal control systems;
 - Legal and professional requirements relating to the exercise of the reserved function(s) concerned; and
 - Standards relating to financial statements.
16. In addition, the body of knowledge should cover at least the following areas insofar as they are relevant to the reserved function(s) concerned:
 - Basic principles of the financial management of undertakings;
 - Business, general and financial economics;
 - Civil and commercial law;
 - Information technology and systems;
 - Law of insolvency and similar procedures;
 - Mathematics and statistics;
 - Provision of financial services, advice, etc.;
 - Professional conduct and ethics;
 - Social security and law of employment; and
 - Tax law.

Applicants should have covered these subjects in a breadth and depth sufficient to enable them to perform the relevant function to the expected standard. In order to ensure that this is the case, a detailed review will need to be made of the respective educational programs and their content.

17. Areas of truly substantial difference (in terms of breadth and depth) in subjects which are considered essential to the practice of the profession in the respective countries should be identified. Applicants seeking recognition will accept that they may be required to take further courses, gain local experience or undergo some further assessment in key subject area(s).
18. There is considerable international diversity in the educational backgrounds of professional accountants and sometimes in the quality of education itself. In particular, in many countries, an undergraduate degree in accounting is required, while others accept different education and/or accept experience in lieu of formal education. Educational standards should not be considered in a vacuum. Rather they should be viewed in the overall context of the experience required for recognition and of evaluation of the professional examinations taken by an applicant of his or her professional background.

Examinations

19. Candidates for recognition of professional qualifications should demonstrate that they have passed an examination of professional competence. This examination must assess not only the necessary level of theoretical knowledge but also the ability to apply that knowledge competently in a practical situation. Objective evaluation of professional examinations thus becomes a key component of the recognition process.
20. Member bodies should not only satisfy themselves that the assessment(s) undergone by applicants indeed tests the body of knowledge and the ability to apply it, but that the policies and procedures for its construction, security and marking are adequate to ensure the integrity of the assessment process. Agreement should also be reached on the need for a periodic review of the education and assessment process for qualifications being recognized so as to ensure that the conditions for recognition continue to apply.
21. The content, rigor, scope and length of professional examinations administered by professional bodies or other examining authorities also vary. Some are case study based, while some make extensive use of objective testing. Some are highly computational, others more discursive. The task is to ensure that applicants have been adequately assessed in relevant areas to the extent necessary to enable them to operate competently in the reserved functions of their choice.

Experience

22. It is crucial to any professional to not only have a sound theoretical knowledge but also to be able to apply that knowledge competently in the world of work.
23. It is suggested that, prior to recognition for the purposes of performing a reserved function, an individual should have completed a minimum of two¹ years approved and properly supervised practical experience primarily in the area of the function concerned and in a suitable professional environment.
24. Member bodies, or other authorities considering recognition of other qualifications, should assess the respective experience requirements and determine how to deal with any emerging differences. Differences normally relate to:
 - The nature and extent of required experience (*e.g.*, in some countries, experience outside public accounting is not regarded as acceptable for purposes of recognition of practice),
 - The length of the period of the experience gained, and
 - The procedures required to certify the experience gained (*e.g.*, some countries require employers attestation, while others rely on periodic reports by those gaining the experience).

Any assessment will need to have due regard to the extent of experience relevant to the reserved function which has been obtained by the applicant. The analysis might result in a requirement that, before recognition in the jurisdiction of the host organization, an applicant might be required to undergo further experience.

25. The host country may also seek to impose a period of practical experience in the host country itself to demonstrate competence in the host country laws, practices and/or regulations. In these instances, such a requirement should be for that purpose only. It should not be unreasonably long for an individual who otherwise meets the basic practical experience requirement, as in paragraph 23.

¹ The suggested two year requirement was subsequently modified by the Education Committee to three years. See International Education Guideline (IEG) 9, paragraph 49 (revised October 1996), to reflect current circumstances.

Other Factors to be Considered

26. Although the basic elements of education, examination and experience will be the foundation of any recognition arrangements, there are several other important factors to be addressed:
- Diversity in accounting and auditing standards may cause problems in the matter of recognition. Such standards develop in response to changing social, economic, legal and political environments. Those countries with extensive technical standards may be hesitant to authorize for practice persons from countries with significantly different technical standards, particularly in the area of the reserved function. This difficulty can be resolved if it is generally accepted that applicants may reasonably be expected to demonstrate an adequate knowledge and understanding of the relevant standards as applied in the host country.
 - Ethical practices differ between countries. When a professional accountant is recognized in a host country, he/she would ordinarily be subject to the host country ethics. Where differences appear significant, however, the host country may be reluctant to accept foreign accountants. As with accounting and auditing standards above, demonstration of knowledge of host country ethical practices is a reasonable expectation. Additionally, reference to the IFAC *Code of Ethics for Professional Accountants* can also be helpful in evaluating the significance of differences.
 - Clearly, if one is to practice competently one needs reasonable written and oral skill in the generally used business language of the host country.
 - Requirements for continuing professional education (CPE), as opposed to pre-qualification education in paragraphs 15-18 above, are becoming more common within the profession as a condition of a right to practice. The effect of a compulsory requirement in this area will need to be addressed since in many countries, CPE is often voluntary. Difficulties will arise where one body has a mandatory CPE policy in place and this is not the case in the jurisdiction of an applicant. In such circumstances, some further qualifications may need to be agreed for persons seeking recognition by the body which has CPE requirements in place. However, any arrangements being made should be reasonable and designed to facilitate applicants in meeting the necessary requirements within a reasonable period.
27. The GATS relates to mutual recognition of professional qualifications. It does not relate to reciprocity of membership in professional organizations. This will be especially important in those countries where the licensing/practice authorization function is separate from the professional accountancy organization. IFAC believes that the spirit of mutual

recognition extends to membership. It encourages all professional accountancy bodies to develop membership classifications or other processes by which recognized foreign professionals can also be part of the accountancy organization. Membership for recognized foreign professionals will help those individuals maintain and enhance their competence in host country practices by access to technical publications, contact with local professional accountants, knowledge of ethical practices and other issues. Enhancing technical competence is of direct benefit to the public interest.

Process of Recognition

28. In attempting to establish procedures for recognition of foreign qualifications, care must be taken to address the differences in the organizational structure for the profession. In a country where the accounting profession/licensing process is not centralized, a national organization might need to negotiate on behalf of its members at provincial or state level with local licensing authorities, which might themselves have widely differing requirements. In some countries, recognition for practice purposes requires membership of the locally recognized accountancy bodies, while in others recognition is gained either through affiliation with such a body or from a governmental licensing authority.
29. The GATS requires that each country establish a process to provide for recognition of foreign qualifications. Moreover, the process must be transparent and be equitable for all those individuals seeking qualification. Some countries and member bodies may already have such processes in place while others have not. In the emerging climate of greater global mobility, the former will now need to review their systems and to create more formal structures and the latter will need to put appropriate facilities in place without delay. The following matters should be addressed:
 - Close lines of contact with professional organizations in other countries, to assess the different standards.
 - A process by which the educational system, curricula and degree programs in foreign countries can be assessed vis-à-vis the local requirements; this will be especially important in those instances where pre-qualification education does not always rely on the university system.
 - Evaluation of the examination system in foreign countries, both as to the content of the examination and the process.
 - Evaluation of the experience requirements and the way in which such experience is monitored and controlled.
 - Establishment of an agency review board, or similar structure, which will analyze the results of the processes above and publish and administer the program to facilitate recognition of foreign

qualifications; such an agency would use international reference points (e.g., IFAC's IEG 9) and would recommend special examinations and other programs to enable applicants to demonstrate competence in uniquely local requirements.

30. Inevitably, such structures will have cost implications. Administrative and legal expenses are examples. These could be significant. It would be reasonable that applicants for recognition should be prepared to contribute to the costs incurred in dealing with their applications and to be aware from the outset of the extent of the charges involved. In some countries, the cost/charge element may be a matter for the state of which the professional organizations/licensing authority is acting.

Barriers Considered as Unrelated to Professional Qualifications

31. The GATS stipulates that qualification requirements should not constitute unnecessary barriers to trade in services and should not be more burdensome than necessary to ensure the quality of service and to protect the public interest.
32. Countries impose various restrictions that do not necessarily relate specifically to professional qualifications. Examples are:
 - Requirements that only citizens are eligible to receive professional titles or licenses;
 - Requirements that candidates for professional titles or licenses must have been resident in the licensing jurisdiction for a period prior to making the application;
 - Requirements that the licensed professional be permanently resident in or permanently established in the licensing jurisdiction; however, if the applicant is not permanently resident or permanently established, he/she could reasonably be expected to demonstrate that he/she intends to practice the reserved function; and
 - Requirements that an applicant attend a specified educational institution or requirements that only a university degree (with no consideration of experience or other types of training) will satisfy educational requirements.

IFAC believes that further research is necessary before it can be concluded as to whether or not such restrictions are unnecessarily burdensome. This research should give due regard, *inter alia*, to the impact on the capacity of the local national profession to develop itself.

Appendix 1

Key Provision of the GATS

Background

The Uruguay Round trade package, negotiated under the auspices of the General Agreement on Tariffs and Trade (GATT) included the first multinational agreement removing obstacles to accountants who wish to practice across borders. Some of these, such as exchange controls and visa restrictions, are faced in common with other service industries and providers. Others, notably difficulties in obtaining certification to practice in foreign jurisdictions, are unique to the professions.

The multilateral agreement, the General Agreement on Trade in Services (GATS), addresses these problems in qualifying to practice in foreign jurisdictions in two ways.

- (1) First, its provisions on domestic regulation require countries to administer their licensing or certification rules in a reasonable, objective and impartial manner and forbids using them as disguised barriers to trade. To carry out this broad mandate, the agreement envisions the development of more specific binding disciplines in the future. Countries are also required to establish specific procedures for verifying the competence and credentials of professionals from other countries.
- (2) Second, the agreement encourages countries to recognize other professionals, either autonomously or through mutual recognition agreements. It further sets out guidelines to ensure that such agreements are not used simply to discriminate against professionals from countries that are not party to them.

Articles of Special Interest to the Accountancy Profession

There are two articles within the GATS that are of particular interest to the accountancy profession:

- Article VI on domestic regulation is one of the rules that only applies to accountancy in cases where individual governments have made specific commitments in their schedules. It contains three important features:
 - Governments agree to apply regulations affecting service industries and professions in a reasonable, objective and impartial manner so that they do not act as barriers to trade.
 - Qualification requirements and procedures, technical standards and licensing requirements should not constitute unnecessary barriers to trade in services. Further disciplines or rules shall be developed on a sector-by-sector basis to make sure such measures are based on objective and transparent criteria, are not more burdensome than necessary to ensure the

quality of the service and, in the case of licensing requirements, do not in themselves serve as restrictions on the supply of the service. International standards should be taken into account in determining compliance with these principles.

- All countries must have adequate procedures in place to verify the qualifications of professional from other countries seeking the right to practice within their jurisdictions.
- Article VII on registration of qualifications and licenses applies across the board to all services and professions in all signatory countries regardless of whether specific commitments have been made. Like Article VI, this article has three features relevant to the accountancy profession:
 - Countries may choose their own approach to recognizing foreign qualifications and licenses, through unilateral recognition, bilateral reciprocal arrangements or international harmonization.
 - There is no obligation for a country to enter into such arrangements. However, if a country decides to do so, whatever approach is chosen must be applied in a consistent, objective and fair manner to all other countries seeking recognition of their professionals.
 - Countries are encouraged to cooperate with intergovernmental and non-governmental organizations toward the establishment and adoption of common international qualifications and standards of practice.

Implementation

The operation of the GATS, as well as the GATT itself and a new agreement on the protection of intellectual property, will be overseen and administered by the new World Trade Organization (WTO). The GATS also creates a Council on Trade in Services made up of representatives from the signatory countries, to continue negotiations on outstanding issues and otherwise to take up questions that arise in the operation of the services agreement.

It is known that, in the context of professional services, the Council on Trade Services will be establishing a working party when the agreement comes into force to oversee the implementation of services agreement and that its work relating to accountancy has been designated as “a matter of priority”.

The following three stage agenda has been set for the working party:

1. The additional disciplines and rules envisioned by Article VI should be developed to make sure that national qualification requirements and procedures, technical standards and licensing requirements in accountancy do not constitute unnecessary barriers to trade.
2. The use of international standards with respect to qualifications and the practice of accountancy should be encouraged through cooperation with relevant international governmental and non-governmental organizations.

RECOGNITION OF PROFESSIONAL ACCOUNTANCY QUALIFICATIONS

IFAC and the IASC are the obvious non-governmental organizations to be involved in this effort.

3. The cross-border recognition of qualifications should be encouraged, in accordance with Article VII, through the development of appropriate guidelines for recognition agreements.

Appendix 2

Examples of Mutual Recognition Initiatives

The European Union

The true legal foundation for the philosophy of mutual recognition was the 1957 Treaty of Rome. However, it took several decades to develop the necessary political will. This happened with The Single European Act 1986 which enshrined the philosophy of mutual recognition. The general system of mutual recognition of diplomas seeks to permit professionals in the European Union to circulate more freely and easily from one member state to another. This system concerns only individuals and ignores firms which may be part of the relevant profession. In addition, the directive relates only to establishment-based provision of services and does not address the question of cross-border provision of services.

The end result sought is the right of the professional to practice his/her profession in the host member state or provide services there under the same conditions as those to which professionals in that country are subject. The progressive implementation of the first directive in member states and the effective organizations of local knowledge examinations for the accountancy profession should result in a significant increase in the number of accountants benefiting from the mutual recognition of diplomas.

North America

The North American Free Trade Agreement (NAFTA) establishes basic rules and obligations to facilitate cross-border trade in services. While recognizing the need for regulation, NAFTA encourages broader market access by providing that licensing requirements must be based on objective and transparent criteria, such as professional competence, and must be no more burdensome than is necessary to ensure the quality of service provided.

In 1991, an agreement was entered into between the Canadian Institute of Chartered Accountants, The American Institute of Certified Public Accountants and the National Association of State Boards of Accountancy which became effective in some, but not all US states in November 1993. A holder of one designation may qualify for the other by passing local knowledge examinations and by meeting certain experience requirements. Candidates for reciprocal recognition, who qualify by passing the local knowledge examinations of one of the bodies, will be exempt from the obligation to write the final qualification examination of that body.

**INTERNATIONAL PROFESSIONAL
PRACTICE STATEMENT 1**

ASSURING THE QUALITY OF PROFESSIONAL SERVICES

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Introduction

1. IFAC's *Code of Ethics for Professional Accountants* notes that "a distinguishing mark of a profession is acceptance of its responsibility to the public." The accountancy profession has acquired a reputation for integrity, objectivity, and competence through its many years of service to clients, employers, and the public. Every professional accountant who fails (or is perceived as failing) to comply with professional standards and legal requirements makes it difficult for the profession to maintain its reputation. IFAC's role is to provide guidance, encourage progress, and promote harmonization. Thus, IFAC believes that member bodies need to demonstrate that there are adequate self-regulatory programs in place to provide reasonable assurance that professional accountants adhere to the highest standards.
2. Regulation of the accountancy profession is carried out cost efficiently and effectively by those dedicated individuals who comprise the profession. It is therefore in the interests of the worldwide accountancy profession, and the public it serves, for member bodies to ensure they carry out and publicize this kind of self-regulatory effort.
3. The duty to adhere to professional requirements rests on the individual professional accountant. However, assessing the extent to which an individual accountant has met this duty is best carried out at the level of the organization for which the professional accountant's work is performed.
4. In the case of employed professional accountants,¹ the implementation of appropriate quality assurance policies and procedures is ordinarily a matter for the organization employing the professional accountant (the employer). Accordingly, this International Professional Practice Statement does not deal with employed professional accountants.
5. In the case of professional accountants in public practice, the implementation of appropriate quality control policies and procedures is the responsibility of each firm of practicing accountants. The task of encouraging and assisting firms of practicing accountants to maintain and improve the quality of professional services is primarily that of the member bodies in each country. IFAC believes that the member bodies have the responsibility to take appropriate steps to achieve that objective in the legal, social, business, and regulatory environment prevailing within their countries. This International Professional Practice Statement discusses the steps that member bodies can take to enhance quality control within accounting firms.

¹ The *Code of Ethics for Professional Accountants* defines an employed accountant as *a professional accountant employed in industry, commerce, the public sector or education*.

Objectives

6. IFAC believes that all firms of professional accountants should have quality control policies and procedures for all professional services and that member bodies should ensure that these policies and procedures are subject to external review. Many segments of society when making decisions increasingly depend upon information over which they have no control; they turn to professional accountants for assistance in assessing the credibility of some of that information. In view of the greater degree of reliance that the public places on assurance engagements, it is appropriate for the review of assurance engagements to be more rigorous than the review of other services.
7. It is not possible for IFAC to outline all of the steps needed to establish effective quality control standards and quality review programs. However, IFAC believes that the following objectives have worldwide applicability and that member bodies should strive to achieve them.
 - Member bodies should adopt or develop quality control standards and relevant guidance that require firms of practicing accountants to establish the quality control policies and procedures necessary to provide reasonable assurance of conforming with professional standards in performing services. The nature and extent of a firm's quality control policies and procedures depend on a number of factors, such as the size and nature of its practice, its geographic dispersion, its organization, and appropriate cost/benefit considerations. Accordingly, the policies and procedures adopted by individual firms will vary, as will the manner in which the policies and procedures themselves and compliance with them are documented.
 - Member bodies should develop quality review programs designed to evaluate whether firms of practicing accountants have established appropriate quality control policies and procedures and are complying with those policies.
 - Member bodies should establish quality review programs designed to evaluate whether firms of practicing accountants have complied with relevant professional standards for assurance engagements.
 - Member bodies should require firms of practicing accountants to make appropriate improvements in their quality control policies and procedures, or in their compliance with those policies and procedures, when the need for such improvement is identified. Where firms fail to comply with relevant professional standards, the member body should take appropriate corrective action. Member bodies should also take such educational or disciplinary measures as indicated by the circumstances.

8. As a basic condition, IFAC emphasizes that implementation of an adequate self-regulatory program cannot be effected until firms of practicing accountants in a country are bound by an appropriate code of ethics and also by adequate standards governing accounting principles and engagements to provide professional services. The IFAC *Code of Ethics for Professional Accountants*, its International Standards on Auditing, and the International Accounting Standards (IASs) issued by the International Accounting Standards Committee (IASC) all provide guidance for such standards.

Establishing Quality Control Standards

9. Member bodies should promulgate or otherwise identify the standards against which it will measure the quality control policies and procedures of firms of practicing accountants. Those standards should set out the objectives of quality controls. It is the responsibility of each firm of practicing accountants to implement policies and procedures that provide reasonable assurance of achieving those objectives. It is also the firm's responsibility to communicate those policies and procedures to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood.
10. General quality control policies and procedures should cover such areas as:
 - (a) The qualities, skills and competence of the firm's personnel;
 - (b) The assignment of personnel to engagements and their direction and supervision;
 - (c) The acceptance of new clients and the retention of existing clients; and
 - (d) The monitoring of quality control procedures.

Appendix 1 sets out the objectives and illustrative examples of general quality control policies and procedures. IFAC believes that they are relevant to all services rendered by a firm of practicing accountants.

Providing Other Quality Control Guidance

11. Member bodies should consider whether firms of practicing accountants in their countries need other assistance to understand the objectives of quality control and to implement appropriate quality control policies and procedures. Assistance can be provided in various forms, depending upon the needs within a country. The following are some examples.
 - Mandating Continuing Professional Education (CPE) when it appears that CPE would be effective in assuring that all practicing accountants obtain adequate training. International Education Guideline 2 "Continuing Professional Education" provides further guidance on CPE programs.

- Developing guidelines for comprehensive CPE programs that may be useful to firms in planning, or evaluating the adequacy of, their in-house training.
- Providing CPE programs to firms and sole practitioners that do not have the resources to develop their own internal programs, including programs specifically directed to the implementation of quality control policies and procedures.
- Providing guidelines for the conduct of effective internal inspection programs.
- Implementing voluntary programs that enable firms of practicing accountants to obtain an independent, confidential assessment of their quality control policies and procedures, apart from any formal program of quality review.

Establishing a Quality Review Program

12. Member bodies should establish a quality review program. The program should be mandatory for all firms that provide professional services. The program should cover the firm's quality control policies and procedures for all professional services, and should cover the firm's adherence to relevant professional standards in respect of assurance engagements. The program may be extended, on a voluntary or mandatory basis, to cover adherence to relevant professional standards in respect of other services. Appendix 2 gives assistance on some of the practical aspects of setting up a quality review program.
13. The first consideration is whether the object of the review program will be the individual professional accountant, or the firm of which the accountant is part. Member bodies may choose to do either, but even where the object of the review program is the individual professional accountant, it will usually be necessary to consider the policies and procedures adopted by the firm of which the accountant is part. When reviewing the firm, the work of all partners conducting assurance engagements may be reviewed, or the work of only some of the partners may be reviewed, with the reviews being increased if the standard is unsatisfactory.
14. The next consideration is the scope of the program itself. All firms may be reviewed over an established period of time, or firms of practicing accountants may be selected for quality review on a test basis (for example, upon a random selection or upon the nature and size of their practices). When the quality review program in a country is carried out on a test basis, IFAC believes that it is important that all firms of practicing accountants should face the possibility of being selected for review.
15. In reaching a decision on the scope of a quality review program, member bodies should consider the following.

- The extent to which all firms of practicing accountants conduct assurance engagements.
 - Governmental, regulatory, or media criticisms of the quality of professional services.
 - The extent to which proposals for quality review programs appear to be supported by the profession or demanded by others.
 - The cost of the program in relation to the financial strength of the practicing profession and of the member body itself.
16. When all firms of practicing accountants in a given country are to have quality reviews, it is possible to control the costs without loss of effectiveness. In particular, the program can be implemented over a reasonable number of years, for example, beginning with firms with more extensive assurance engagements, on whom there may be greater public reliance. During that phase-in period, the member body would continue educational efforts to help firms develop effective quality control policies and procedures, and to prepare for review. At the same time, it would be prudent for the member body to use its best efforts to communicate to government and to the public the extent of this commitment by the profession to maintain and improve the quality of service.
 17. Where a quality review of a firm's assurance engagements is being undertaken, that review should address the firm's work product as well as its quality control procedures. Quality reviews of other types of work may be limited to a consideration of the quality control policies and procedures.
 18. Personal visits to a firm to conduct a quality review should produce the most benefit to the firm and to the public. For this reason, the partners and senior staff members of the firm should be encouraged to participate in a discussion of the review's findings. Accordingly, this approach should be taken wherever possible and appropriate. The member body should set up a committee to consider the findings, and the firm's partners should be permitted to make representations to that committee.
 19. The next major consideration is whether the reviews are to be conducted by practicing accountants, by non-practicing accountants engaged by the member body, or by its own employees. The services rendered by firms of practicing accountants require a comprehensive knowledge of professional standards and, in many cases, legal, regulatory, and tax requirements. They usually call for knowledge of the client's business and of matters affecting the industry in which the client operates, such as economic conditions, government regulations, and changes in technology. They may involve special expertise in matters as diverse as, for example, information processing, hedging transactions, and valuation methods. Practicing accountants would ordinarily be expected to have current knowledge of such matters and, therefore, should be well suited to carry out quality reviews of other firms of practicing accountants. The member body should

ensure that the review program used by firms is based upon programs it has approved. It should also adopt reasonable oversight procedures to provide added assurance that quality reviews are carried out in an independent, objective manner.

20. All people conducting reviews should also be instructed in the need to carry out their procedures, whenever possible, in a manner that elicits full cooperation from the firms being reviewed, and to maintain the confidentiality of client information.
21. Where quality reviews are to be carried out by non-practicing accountants engaged by the member body, or by its own professionally qualified employees, it should insure that the individuals involved have a current knowledge of applicable professional and quality control standards and the manner in which firms of practicing accountants implement those standards.
22. The number of alternative approaches that exist make it evident that each member body will have to agree upon the appropriate alternatives. It will also need to publish its program in the form of reasonably detailed standards and procedures. In that connection, IFAC believes that it is important for a successful quality review program to have standards that address at least the following matters.
 - Assuring that reviewers receive training in the conduct of reviews.
 - Assuring the independence and objectivity of reviewers.
 - Assuring that reviewers have the technical skill and knowledge and the specialized experience to perform the review with professional competence.
 - Documenting the review procedures followed in a manner that permits an objective assessment of whether the review was performed with due care and in compliance with its standards.
 - Reporting the findings of the review in a manner that assists the reviewed firm in identifying and implementing any necessary corrective actions and in making other desirable improvements in its quality control policies and procedures.
 - Requiring, where applicable, the imposition of added corrective, educational, or monitoring procedures pursuant to guidelines that assure that firms will be treated fairly and consistently. Examples of such procedures are requirements for changes in quality control policies and procedures, for specified continuing professional education, or for follow up visits by reviewers to obtain assurance that corrective actions planned by the firm have been appropriately implemented.

- Imposing disciplinary measures on firms that either refuse to cooperate in the conduct of the review, fail to take necessary corrective action, or are found to have serious deficiencies that cannot be dealt with in a meaningful way by remedial or educational measures.
 - Maintaining the confidentiality of client information.
23. Member bodies establishing a quality review program will also need to develop specific administrative procedures to guide the selection of reviewers, to monitor the progress of reviews, to evaluate the performance of reviewers, and to deal with the resolution of differences of professional opinion on matters related to the review.
24. Finally, the number of tasks enumerated above (and each member body implementing a quality review program will identify many others) makes it evident that careful advance planning, committed members, qualified staff at the member body, and comprehensive training and communications programs are essential to success.

Appendix 1

Quality Control Policies and Procedures

Personnel Qualities

1. Personnel in the firm should adhere to the principles of integrity, objectivity, independence, and confidentiality.
2. Quality control standards should encourage firms of practicing accountants to adopt quality control policies and procedures that provide the firm with reasonable assurance that:
 - The firm's policies on matters involving integrity, objectivity, independence, and confidentiality as they relate to the various types of services provided by the firm are communicated to personnel at all levels within the firm.
 - Questions on these matters are identified and resolved by individuals at appropriate management levels.
 - Compliance with the firm's policies and procedures relating to independence is monitored.

Skills and Competence

3. The firm should be staffed by personnel who have attained and maintain the skills and competence required to enable them to fulfill their responsibilities.
4. Quality control standards should encourage firms of practicing accountants to adopt quality control policies and procedures that provide them with reasonable assurance that:
 - The firm's recruiting program will meet the firm's personnel needs and that personnel hired by the firm, both inexperienced and experienced, will have integrity and the other attributes, achievements, and experience necessary to enable them to perform with skill and competence.
 - The firm's continuing professional education (CPE) and training programs are carried out in compliance with guidelines designed to provide personnel with the knowledge required to fulfill their responsibilities and to progress within the firm.
 - Personnel are informed about the responsibilities of their positions, counseled on a timely basis on their performance, progress, and career opportunities, and advanced to positions of greater responsibility in accordance with guidelines that give appropriate recognition to the quality of their work.

Assignment

5. Work should be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
6. Quality control standards should encourage firms of practicing accountants to adopt quality control policies and procedures that provide them with reasonable assurance that:
 - In assigning personnel to engagements, appropriate consideration is given to the workload requirements of an engagement, the skills and competence required by an engagement, the experience and competence of personnel in relation to the complexity or other requirements of an engagement, the extent of supervision to be provided, and other relevant factors.
 - Assignment decisions are made by individuals charged with that responsibility, and the decision is approved by the person responsible for the conduct of the specific engagement.

Direction and Supervision

7. There should be sufficient direction and supervision of work at all levels to provide the firm with reasonable assurance that the work performed by the firm meets appropriate standards of quality. Whenever necessary, consultation should be made with those who have appropriate expertise.
8. Quality control standards should encourage firms of practicing accountants to adopt quality control policies and procedures that provide them with reasonable assurance that:
 - Work is properly planned by appropriate personnel.
 - Work is properly supervised at all organizational levels, considering the training, ability, and experience of the personnel assigned.
 - Other appropriate procedures for maintaining the firm's standards of quality are complied with (such as policies and procedures for the conduct of the work, standardized forms, checklists and questionnaires, and procedures for resolving differences of professional opinion).
 - Personnel consult with or use authoritative sources on specialized, complex, or unusual matters; to that end, situations requiring consultation and the persons or sources to be consulted should be identified, appropriate reference libraries should be maintained, and the extent to which consultation should be documented should be specified.
 - Appropriate on-the-job training is provided.
 - Guidelines for the review of the work performed and of the work product are complied with; such guidelines should deal, among other

things, with the qualifications of the reviewer, the documentation of the review, and the types of situations that call for a review by an individual having no other responsibility for the engagement.

Acceptance and Retention of Clients

9. The firm should carry out an evaluation of a prospective client prior to acceptance and should review, on an ongoing basis, its association with present clients. In making a decision to accept or retain a client, the firm should consider the nature of the work contemplated by the engagement, circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting special risks, its own independence (where required), its ability to service the client properly, and the integrity of the client's management.
10. Quality control standards should encourage firms of practicing accountants to adopt quality control policies and procedures that provide them with reasonable assurance that:
 - Present and prospective clients are evaluated consistently against guidelines relevant to the firm and its practice by individuals at appropriate management levels.
 - Adequate procedures exist for identifying and addressing conditions that would have caused the firm to reject a client had such conditions existed at the time of initial acceptance and that those procedures are complied with.
 - There is a clear understanding with clients about the objectives, nature, scope and limitations of an engagement, ordinarily through preparation of an engagement letter.

Inspection

11. The firm should monitor the effectiveness of its quality control policies and procedures.
12. Quality control standards should encourage firms of practicing accountants to adopt quality control policies and procedures that provide them with reasonable assurance that:
 - The scope and content of the firm's inspection program are appropriately defined in relation to the size of the firm, the nature of its practice, the degree of operating autonomy allowed to its personnel and operating offices, and other procedures the firm follows to assist it in monitoring compliance with other quality control policies and procedures (such as a "cold" review of working papers and reports).
 - The inspection program is carried out by personnel with the necessary competence and experience.

- Corrective actions indicated by inspection findings are implemented on a timely basis.

Appendix 2

Implementation Guide

Introduction

1. This implementation guide is intended to provide assistance to member bodies in their implementation of Council's Statement of Policy on *Assuring the Quality of Professional Services*.

Initial Steps

2. The first point to consider is whether the body's constitution permits it to operate a quality review scheme. If the constitution does not, then it should be altered accordingly. Similarly, the rules on client confidentiality need to be examined to ensure that the operation of a review scheme would not break those rules. Any relevant laws would also need to be considered.
3. Member bodies have to decide at an early stage whether the reviews:
 - (a) Will be carried out by their own employees or by other firms of professional accountants in public practice; and
 - (b) Will be paid for on a "per review basis" by firms that are reviewed or whether the cost of the review system is funded by a general levy on members as a whole or on members in public practice.
4. The scope of the review needs to be established at an early stage. The member body needs to ensure that there are appropriate professional standards against which the practicing firm can be measured.

The Next Stages

5. The member body also needs to set up an appropriate infrastructure internally for considering the results of reviews. For example, a bad review (or a series of bad reviews) should lead to appropriate regulatory and disciplinary action, and may lead to professional accountants having their licenses to practice revoked. An appropriate committee and appeal structure need to be put in place.
6. Where the reviews are to be carried out by employees of the member body, then the body needs to recruit sufficient professional accountants with appropriate experience. Those people need to be integrated into the body's structure.
7. Where the reviews are to be carried out by firms of professional accountants in public practice, criteria for selecting suitable firms need to be prepared. The body also needs to decide whether it will select the firm to carry out a particular review, or whether the firm being reviewed may select its own reviewer. Where firms may select their own reviewers then the

body needs to establish a mechanism to ensure that the firm conducting the review is suitable.

8. Those conducting reviews (whether employees of the member body or firms of professional accountants) need to receive training in review procedures. A mechanism needs to be set up that ensures consistency between reviewers, and allows for the pooling of experience. This will include the design of suitable review programs for those conducting reviews.
9. The body then needs to consider the following further points, which have important implications for the smooth running of the scheme.
 - (a) Will the reviews be of individual professional accountants, or of firms of professional accountants? If it is of firms, will each partner be subject to review, or will only a sample of some of the partners be chosen?
 - (b) Is it intended that all firms will be reviewed within a given period, or is it intended that only a sample will be chosen each year and that some firms might never be reviewed?
10. The member body will need to establish a mechanism to keep track of those providing professional services to provide a base for the selection of those being reviewed.

Introducing the Scheme

11. It is important that members are informed about the introduction of the scheme and what aspects of their work will fall within the scheme. In some cases member bodies may wish to set up practice advisory schemes whereby professional accountants in public practice can receive confidential assistance on practice management or technical issues.
12. The purpose of a review is to help the firm, and the member body, be sure that work is carried out in accordance with professional standards. The review process should not be confrontational, but should be carried out in a spirit of mutual co-operation. This also helps the review to be carried out speedily and efficiently. This factor should be borne in mind when designing the training programs for those conducting reviews.
13. In most cases it is essential for firms to be given advance warning of the review. This is because they will often need to gather information together and because the partners concerned will need to be available to answer questions when the review is being carried out. Similarly, the reviewers should discuss their findings with the firm being reviewed before issuing the final report.
14. There will need to be a system for monitoring the reviews. Where the outcome of a review is less than satisfactory, then that information needs to be passed on to the appropriate committee. It may also be appropriate to

schedule the firm for a follow up visit earlier than would otherwise be the case.