AU-C Section 315

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

Source: SAS No. 122; SAS No. 128.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

NOTE

In October 2015, the Auditing Standards Board issued SAS No. 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (sec. 940), which contains amendments to this section.

The amendments are effective for integrated audits for periods ending on or after December 15, 2016, and can be viewed in the appendix of section 940 until the effective date, when they will be applied to this section.

Introduction

Scope of This Section

.01 This section addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control.

Effective Date

.02 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

Objective

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

Definitions

.04 For purposes of generally accepted auditing standards (GAAS), the following terms have the meanings attributed as follows:

Assertions. Representations by management, explicit or otherwise, that are embodied in the financial statements as used by the auditor to consider the different types of potential misstatements that may occur.

Business risk. A risk resulting from significant conditions, events, circumstances, actions, or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies or from the setting of inappropriate objectives and strategies.

Internal control. A process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives.[1]

Relevant assertion. A financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of internal controls. (Ref: par. .A131)

Risk assessment procedures. The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels.

Significant risk. An identified and assessed risk of material misstatement that, in the auditor's professional judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

.05 The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: par. .A1–.A5)

.06 The risk assessment procedures should include the following:

a. Inquiries of management, appropriate individuals within the internal audit function (if such function exists), others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error (Ref: par. .A6–.A13)

b. Analytical procedures (Ref: par. .A14–.A17)

c. Observation and inspection (Ref: par. .A18)

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

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

.07 The auditor should consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.

.08 If the engagement partner has performed other engagements for the entity, the engagement partner should consider whether information obtained is relevant to identifying risks of material misstatement.

.09 During planning, the auditor should consider the results of the assessment of the risk of material misstatement due to fraud[2] along with other information gathered in the process of identifying the risks of material misstatements.

.10 When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor should determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: par. .A19–.A20)

.11 The engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: par. .A21–.A23)

Understanding the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment (Ref: par. .A24)

.12 The auditor should obtain an understanding of the following:

a. Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework. (Ref: : par. .A25–.A29)

b. The nature of the entity, including

  i. its operations;

  ii. its ownership and governance structures;

  iii. the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and

  iv. the way that the entity is structured and how it is financed,

  to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: par. .A30–.A34)

c. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: par. .A35)

d. The entity's objectives and strategies and those related business risks that may result in risks of material misstatement. (Ref: par. .A36–.A42)

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[2] See section 240, *Consideration of Fraud in a Financial Statement Audit*.

e. The measurement and review of the entity's financial performance. (Ref: par. .A43–.A48

The Entity's Internal Control

.13 The auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: par. .A49–.A74)

Nature and Extent of the Understanding of Relevant Controls

.14 When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. (Ref: par. .A75–.A77)

Components of Internal Control

.15 *Control environment.* The auditor should obtain an understanding of the control environment. As part of obtaining this understanding, the auditor should evaluate whether

a. management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and

b. the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment. (Ref: par. .A78–.A88)

.16 *The entity's risk assessment process.* The auditor should obtain an understanding of whether the entity has a process for

a. identifying business risks relevant to financial reporting objectives,

b. estimating the significance of the risks,

c. assessing the likelihood of their occurrence, and

d. deciding about actions to address those risks. (Ref: par. .A89–.A90)

.17 If the entity has established a risk assessment process (referred to hereafter as the *entity's risk assessment process*), the auditor should obtain an understanding of it and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor should evaluate whether an underlying risk existed that the auditor expects would have been identified by the entity's risk assessment process. If such a risk exists, the auditor should obtain an understanding of why that process failed to identify it and evaluate whether the process is appropriate to its circumstances or determine if a significant deficiency or material weakness exists in internal control regarding the entity's risk assessment process.

.18 If the entity has not established such a process or has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor should evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material weakness in the entity's internal control. (Ref: par. .A91)

.19 *The information system, including the related business processes relevant to financial reporting and communication*. The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:

a. The classes of transactions in the entity's operations that are significant to the financial statements.

b. The procedures within both IT and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.

c. The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions. This includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.

d. How the information system captures events and conditions, other than transactions, that are significant to the financial statements.

e. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

f. Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments. (Ref: par. .A92–.A96)

.20 The auditor should obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including

a. communications between management and those charged with governance and

b. external communications, such as those with regulatory authorities. (Ref: par. .A97–.A98)

.21 *Control activities relevant to the audit*. The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances. (Ref: par. .A99–.A105)

.22 In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. (Ref: par. .A106–.A109)

.23 *Monitoring of controls.* The auditor should obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: par. .A110–.A111)

.24 If the entity has an internal audit function,[3] the auditor should obtain an understanding of the nature of the internal audit function's responsibilities how the internal audit function fits in the entity's organizational structure, and the activities performed or to be performed. (Ref: par. .A113–.A120) [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.25 The auditor should obtain an understanding of the sources of the information used in the entity's monitoring activities and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: par. .A121)

Identifying and Assessing the Risks of Material Misstatement

.26 To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at

a. the financial statement level and (Ref: par. .A122–.A125)

b. the relevant assertion level for classes of transactions, account balances, and disclosures. (Ref: par. .A126–.A133)

.27 For this purpose, the auditor should

a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: par. .A134–.A135)

b. assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

c. relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: par. .A136–.A138)

d. consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks That Require Special Audit Consideration

.28 As part of the risk assessment described in paragraph .26, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk.

.29 In exercising professional judgment about which risks are significant risks, the auditor should consider at least

a. whether the risk is a risk of fraud;

b. whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention;

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[3] Paragraph .13 of section 610, *Using the Work of Internal Auditors*, defines the term *internal audit function* for purposes of GAAS. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

c. the complexity of transactions;

d. whether the risk involves significant transactions with related parties;

e. the degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

f. whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual. (Ref: par. .A139–.A143)

.30 If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks. (Ref: par. .A144–.A146)

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

.31 In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit, and the auditor should obtain an understanding of them. (Ref: par. .A147–.A150)

Revision of Risk Assessment

.32 The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances in which the auditor obtains audit evidence from performing further audit procedures or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly. (Ref: par. .A151)

Documentation

.33 The auditor should include in the audit documentation [4] the

a. discussion among the engagement team required by paragraph .11, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated;

b. key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph .12 and each of the internal control components specified in paragraphs .15–.25, the sources of information from which the understanding was obtained, and the risk assessment procedures performed;

c. identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level, as required by paragraph .26; and

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[4] Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

d. risks identified and related controls about which the auditor has obtained an understanding as a result of the requirements in paragraphs .28–.31. (Ref: par. .A152–.A155)

Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities (Ref: par. .05)

.A1 Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an *understanding of the entity*), is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example

- assessing risks of material misstatement of the financial statements;
- determining materiality in accordance with section 320, *Materiality in Planning and Performing an Audit*;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas for which special audit consideration may be necessary (for example, related party transactions, the appropriateness of management's use of the going concern assumption, considering the business purpose of transactions, or the existence of complex and unusual transactions);
- developing expectations for use when performing analytical procedures;
- responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management's oral and written representations.

.A2 Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and relevant assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

.A3 The auditor is required to exercise professional judgment[5] to determine the extent of the required understanding of the entity. The auditor's primary consideration is whether the understanding of the entity that has been obtained is sufficient to meet the objective stated in this section. The depth

[5] Paragraph .18 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, requires the auditor to exercise professional judgment in planning and performing an audit. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

.A4 The risks to be assessed include both those due to fraud and those due to error, and both are covered by this section. However, the significance of fraud is such that further requirements and guidance are included in section 240, *Consideration of Fraud in a Financial Statement Audit*, regarding risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.

.A5 Although the auditor is required to perform all the risk assessment procedures described in paragraph .06 in the course of obtaining the required understanding of the entity (see paragraphs .12–.25), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed when the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include the following:

- Reviewing information obtained from external sources, such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications
- Making inquiries of the entity's external legal counsel or valuation specialists whom the entity has used

Inquiries of Management and Others Within the Entity (Ref: par. .06a)

.A6 Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A7 The auditor also may obtain information or a different perspective in identifying risks of material misstatement through inquiries of others within the entity and other employees with different levels of authority. For example

- inquiries directed toward those charged with governance may help the auditor understand the environment in which the financial statements are prepared. Section 260 [6] identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
- inquiries of employees involved in initiating, authorizing, processing, or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, postsales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contract terms.
- inquiries directed toward marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

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[6] Paragraph .05*d* of section 260, *The Auditor's Communication With Those Charged With Governance*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

- inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A8 Because obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

Inquiries of the Internal Audit Function (Ref: par. .06a)

.A9 If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the external auditor in obtaining an understanding of the entity and its environment and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the external auditor's understanding of the entity, the external auditor's risk assessments, or other aspects of the audit. The external auditor's inquiries, therefore, are made regardless of whether the external auditor expects to use the work of the internal audit function to modify the nature or timing or reduce the extent of audit procedures to be performed.[7] Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A10 If, based on responses to the external auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the external auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A11 In addition, in accordance with section 240,[8] if the internal audit function provides information to the external auditor regarding any actual, suspected, or alleged fraud, the auditor takes this into account in the external auditor's identification of risk of material misstatement due to fraud. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A12 Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the external auditor's judgment,

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[7] The relevant requirements are contained in section 610, *Using the Work of Internal Auditors*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

[8] Paragraph .19 of section 240. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

have the appropriate knowledge, experience, and authority (such as the chief internal audit executive or, depending on the circumstances, other personnel within the function). The external auditor may also consider it appropriate to have periodic meetings with these individuals. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

Considerations Specific to Governmental Entities (Ref: par. .06a)

.A13 External auditors of governmental entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the external auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

Analytical Procedures (Ref: par. .06b)

.A14 Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information (for example, the relationship between sales and square footage of selling space or volume of goods sold). [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A15 Analytical procedures may enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior audit and also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A16 However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Considerations Specific to Smaller, Less Complex Entities

.A17 Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Observation and Inspection (Ref: par. .06c)

.A18 Observation and inspection may support inquiries of management and others and also may provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations
- Documents (such as business plans and strategies), records, and internal control manuals
- Reports prepared by management (such as quarterly management reports and interim financial statements), those charged with governance (such as minutes of board of directors' meetings), and internal audit
- The entity's premises and plant facilities

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Information Obtained in Prior Periods (Ref: par. .10)

.A19 The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as

- past misstatements and whether they were corrected on a timely basis.
- the nature of the entity and its environment and the entity's internal control (including deficiencies in internal control).
- significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A20 Paragraph .10 requires the auditor to determine whether information obtained in prior periods remains relevant if the auditor intends to use that information for the purposes of the current audit. For example, changes in the control environment may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Discussion Among the Engagement Team (Ref: par. .11)

.A21 The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement

- provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial

statements in the specific areas assigned to them and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.

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

This discussion may be held concurrently with the discussion among the engagement team that is required by section 240 to discuss the susceptibility of the entity's financial statements to fraud.[9] Section 240 further addresses the discussion among the engagement team about the risks of fraud. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A22 It is not always necessary or practical for the discussion to include all members in a single discussion (as in group audits), nor is it necessary for all the members of the engagement team to be informed of all the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team, including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Considerations Specific to Smaller, Less Complex Entities

.A23 Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Understanding the Entity and Its Environment, Including the Entity's Internal Control

.A24 Appendix A, "Understanding the Entity and Its Environment," contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment. Appendix B, "Internal Control Components," contains a detailed explanation of the internal control components. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

The Entity and Its Environment

Industry, Regulatory, and Other External Factors (Ref: par. .12a)

.A25 *Industry factors*. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include

- the market and competition, including demand, capacity, and price competition.
- cyclical or seasonal activity.

[9] Paragraph .15 of section 240. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

- product technology relating to the entity's products.
- energy supply and cost.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A26 The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team includes members with sufficient, relevant knowledge and experience, as required by section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A27 *Regulatory factors*. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include the following:

- Accounting principles and industry-specific practices
- Regulatory framework for a regulated industry
- Laws and regulations that significantly affect the entity's operations, including direct supervisory activities
- Taxation (corporate and other)
- Government policies currently affecting the conduct of the entity's business, such as monetary (including foreign exchange controls), fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies
- Environmental requirements affecting the industry and the entity's business

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A28 Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A29 *Other external factors*. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Nature of the Entity (Ref: par. .12b)

.A30 An understanding of the nature of an entity enables the auditor to understand such matters as

- whether the entity has a complex structure (for example, with subsidiaries or other components in multiple locations). Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or investments in entities formed to accomplish specific objectives are accounted for appropriately.

- the ownership and relations between owners and other people or entities. This understanding assists in determining whether related party transactions and balances have been identified and accounted for appropriately. Section 550, *Related Parties*, addresses the auditor's considerations relevant to related parties.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A31 Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include

- business operations such as
  - — the nature of revenue sources, products or services, and markets, including involvement in electronic commerce, such as Internet sales and marketing activities.
  - — the conduct of operations (for example, stages and methods of production or activities exposed to environmental risks).
  - — alliances, joint ventures, and outsourcing activities.
  - — geographic dispersion and industry segmentation.
  - — the location of production facilities, warehouses, and offices and the location and quantities of inventories.
  - — key customers and important suppliers of goods and services.
  - — employment arrangements (including the existence of union contracts, pension and other postemployment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
  - — research and development activities and expenditures.
  - — transactions with related parties.
- investments and investment activities such as
  - — planned or recently executed acquisitions or divestitures.
  - — investments and dispositions of securities and loans.
  - — capital investment activities.
  - — investments in nonconsolidated entities, including partnerships, joint ventures, and investments in entities formed to accomplish specific objectives.
- financing and financing activities such as
  - — major subsidiaries and associated entities, including consolidated and nonconsolidated structures.
  - — debt structure and related terms, including off balance sheet financing arrangements and leasing arrangements.
  - — beneficial owners (local and foreign and their business reputation and experience) and related parties.
  - — the use of derivative financial instruments.
- financial reporting such as
  - — accounting principles and industry-specific practices, including industry-specific significant categories (for example, loans and investments for banks or research and development for pharmaceuticals).

— revenue recognition practices.
— accounting for fair values.
— foreign currency assets, liabilities, and transactions.
— accounting for unusual or complex transactions, including those in controversial or emerging areas (for example, accounting for stock-based compensation).

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A32 Significant changes in the entity from prior periods may give rise to, or change risks of, material misstatement. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A33 *Entities formed to accomplish specific purposes*. An entity may form an entity that is intended to accomplish a narrow and well-defined purpose (for example, a variable interest entity), such as to effect a lease or a securitization of financial assets or to carry out research and development activities. It may take the form of a corporation, trust, partnership, or unincorporated entity. The entity on behalf of which an entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, and other parties may provide the funding to the latter. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A34 Financial reporting frameworks often specify detailed conditions that are deemed to amount to control or circumstances under which an entity should be considered for consolidation. The financial reporting frameworks also may specify different bases for recognition of income related to transactions with these entities. The interpretation of the requirements of such frameworks often involves a detailed knowledge of the relevant agreements involving an entity formed for a specific purpose. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

The Entity's Selection and Application of Accounting Policies (Ref: par. .12c)

.A35 An understanding of the entity's selection and application of accounting policies may encompass such matters as

- the methods the entity uses to account for significant and unusual transactions.
- the effect of significant accounting policies in controversial or emerging areas for which a lack of authoritative guidance or consensus exists.
- significant changes in the entity's accounting policies and disclosures and the reasons for such changes.
- financial reporting standards, and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.
- the financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting standards.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Objectives and Strategies and Related Business Risks (Ref: par. .12d)

.A36 The entity conducts its business in the context of industry, regulatory, and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A37 Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change also may give rise to business risk. Business risk may arise, for example, from

- the development of new products or services that may fail;
- a market that, even if successfully developed, is inadequate to support a product or service; or
- flaws in a product or service that may result in liabilities and reputational risk.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A38 An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement. This is because most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A39 Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies, and related business risks that may result in a risk of material misstatement of the financial statements include

- industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- new products and services (a potential related business risk might be, for example, product liability is increased).
- expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation or a cost increase).
- regulatory requirements (a potential related business risk might be, for example, that legal exposure is increased).
- current and prospective financing requirements (a potential related business risk might be, for example, financing is lost due to the entity's inability to meet requirements).
- use of IT (a potential related business risk might be, for example, systems and processes are incompatible).
- the effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A40 A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, also may have a longer term consequence, which may lead the auditor to consider whether those conditions, in the aggregate, indicate that substantial doubt could exist about the entity's ability to continue as a going concern.[10] Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are provided in appendix C, "Conditions and Events That May Indicate Risks of Material Misstatement." [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A41 Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraphs .16 and .A89–.A91. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A42 *Considerations specific to governmental entities*. For the audits of governmental entities, management objectives may be influenced by concerns regarding public accountability and may include objectives that have their source in law or regulation. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Measurement and Review of the Entity's Financial Performance (Ref: par. .12e)

.A43 Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management or others to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. Section 240 addresses the risks of fraud. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A44 The measurement and review of financial performance are not the same as the monitoring of controls (discussed as a component of internal control in paragraphs .23–.25 and .A110–.A121), though their purposes may overlap as follows:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

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[10] See section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. [Footnote revised, August 2012, to reflect conforming changes necessary due to the issuance of SAS No. 126. Footnote renumbered by the issuance of SAS No. 128, January 2015.]

.A45 Examples of internally generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include

- key performance indicators (financial and nonfinancial) and key ratios, trends, and operating statistics.
- period-on-period financial performance analyses.
- budgets; forecasts; variance analyses; segment information; and divisional, departmental, or other-level performance reports.
- employee performance measures and incentive compensation policies.
- comparisons of an entity's performance with that of competitors.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A46 External parties also may measure and review the entity's financial performance. For example, external information, such as analysts' reports and credit rating agency reports, may represent useful information for the auditor. Such reports often can be obtained from the entity being audited. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A47 Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures also may indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared with that of other entities in the same industry. Such information, particularly if combined with other factors, such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A48 Considerations specific to smaller, less complex entities. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that management relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, an increased risk of misstatements not being detected and corrected may exist. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

The Entity's Internal Control

.A49 An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A50 The following application material on internal control is presented in four sections:

- "General Nature and Characteristics of Internal Control"
- "Controls Relevant to the Audit"
- "Nature and Extent of the Understanding of Relevant Controls"
- "Components of Internal Control—Control Environment"

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

General Nature and Characteristics of Internal Control (Ref: par. .13)

.A51 *Purpose of internal control*. Internal control is designed, implemented, and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern

- the reliability of the entity's financial reporting,
- the effectiveness and efficiency of its operations, and
- its compliance with applicable laws and regulations.

The way in which internal control is designed, implemented, and maintained varies with an entity's size and complexity. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A52 *Considerations specific to smaller, less complex entities*. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures or detailed written policies. For some entities, in particular very small entities, the owner-manager (the proprietor of an entity who is involved in running the entity on a day-to-day basis) may perform functions that in a larger entity would be regarded as belonging to several of the components of internal control. Therefore, the components of internal control may not be clearly distinguished within smaller entities, but their underlying purposes are equally valid. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A53 *Limitations of internal control*. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision making can be faulty and that breakdowns in internal control can occur because of human error. For example, an error in the design of, or in the change to, a control may exist. Equally, the operation of a control may not be effective, such as when information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A54 Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into undisclosed agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A55 Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement and the nature and extent of the risks it chooses to assume. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A56 *Considerations specific to smaller, less complex entities*. Smaller entities often have fewer employees, which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A57 *Division of internal control into components*. The division of internal control into the following five components, for purposes of GAAS, provides a useful framework for auditors when considering how different aspects of an entity's internal control may affect the audit:

a. The control environment

b. The entity's risk assessment process

c. The information system, including the related business processes relevant to financial reporting and communication

d. Control activities

e. Monitoring of controls

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A58 The division does not necessarily reflect how an entity designs, implements, and maintains internal control or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control and their effect on the audit other than those used in this section, provided that all the components described in this section are addressed. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A59 Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs .A78–.A121. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A60 *Characteristics of manual and automated elements of internal control relevant to the auditor's risk assessment*. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A61 An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives and its operating units or business functions. For example, an entity may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, an entity may have complex, highly integrated systems that share data and that are used to support all aspects of the entity's financial reporting, operations, and compliance objectives. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A62 The following use of manual or automated elements in internal control also affects the manner in which transactions are initiated, authorized, recorded, processed, and reported:

- Controls in a manual system may include such procedures as approvals and reviews of transactions and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, authorize, record, process, and report transactions, in which case records in electronic format replace paper documents.

- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT or may use information produced by IT. They also may be limited to monitoring the effective functioning of IT and automated controls and to handling exceptions. When IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A63 Generally, IT benefits an entity's internal control by enabling an entity to

- consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- enhance the timeliness, availability, and accuracy of information;
- facilitate the additional analysis of information;
- enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- reduce the risk that controls will be circumvented; and
- enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A64 IT also poses specific risks to an entity's internal control, including, for example

- reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions. Particular risks may arise when multiple users access a common database.
- the possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties.
- unauthorized changes to data in master files.
- unauthorized changes to systems or programs.
- failure to make necessary changes to systems or programs.
- inappropriate manual intervention.
- potential loss of data or inability to access data as required.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A65 Manual elements in internal control may be more suitable when judgment and discretion are required, such as for the following circumstances:

- Large, unusual, or nonrecurring transactions
- Circumstances in which errors are difficult to define, anticipate, or predict
- Changing circumstances that require a control response outside the scope of an existing automated control
- Monitoring of the effectiveness of automated controls

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A66 Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden, and they also are more prone to simple errors and mistakes. Consistency of application of a manual control element cannot, therefore, be assumed. Manual control elements may be less suitable for the following circumstances:

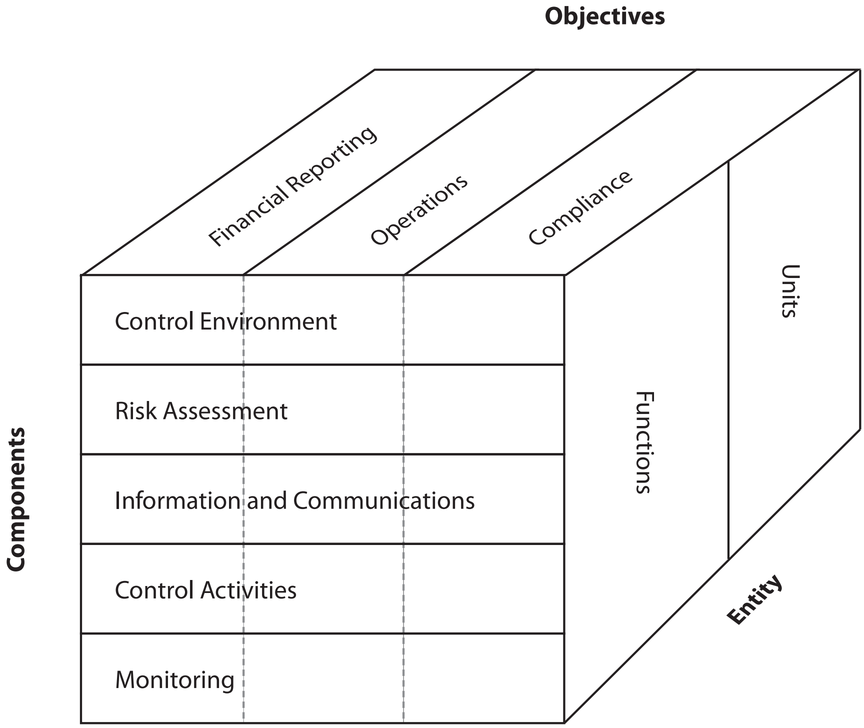
- High volume or recurring transactions or in situations in which errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated
- Control activities in which the specific ways to perform the control can be adequately designed and automated

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A67 The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. For example, multiple users, either external or internal, may access a common database of information that affects financial reporting. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to, or destruction of, data. When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This could result in unauthorized transactions or changes to programs or data that affect the financial statements. The entity responds to the risks arising from the use of IT or the use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Controls Relevant to the Audit

.A68 A direct relationship exists between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives and, therefore, controls relate to financial reporting, operations, and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment. This relationship is depicted as follows:



Although internal control applies to the entire entity or any of its operating units or business functions, an understanding of internal control relating to each of the entity's operating units and business functions may not be necessary to the performance of the audit. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A69 Factors relevant to the auditor's professional judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality
- The significance of the related risk
- The size of the entity
- The nature of the entity's business, including its organization and ownership characteristics
- The diversity and complexity of the entity's operations
- Applicable legal and regulatory requirements
- The circumstances and the applicable component of internal control
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A70 Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further audit procedures. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A71 Controls relating to operations and compliance objectives also may be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or controls pertaining to detecting noncompliance with laws and regulations that may have a direct effect on the determination of material amounts and disclosures in the financial statements,[11] such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A72 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A73 An entity generally has controls relating to objectives that are not relevant to an audit and, therefore, need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A74 *Considerations specific to governmental entities*. Governmental entity auditors often have additional responsibilities with respect to internal control (for example, to report on internal control over financial reporting and on internal control over compliance with law, regulation, and provisions of contracts or grant agreements, violations of which could have a direct effect on the determination of material amounts and disclosures in the financial statements). Governmental entity auditors also may have responsibilities to report on the compliance with law or regulation. As a result, their review of internal control may be broader and more detailed. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Nature and Extent of the Understanding of Relevant Controls (Ref: par. .14)

.A75 Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. Assessing the implementation of a control that is not effectively designed is of little use, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency or material weakness

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[11] See section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

in the entity's internal control. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A76 Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include

- inquiring of entity personnel.
- observing the application of specific controls.
- inspecting documents and reports.
- tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A77 Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless some automation provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph .A63), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls, such as those over program changes. Tests of the operating effectiveness of controls are further described in section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.*[12] [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Components of Internal Control—Control Environment (Ref: par. .15)

.A78 The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A79 Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

a. *Communication and enforcement of integrity and ethical values*. Essential elements that influence the effectiveness of the design, administration, and monitoring of controls.

b. *Commitment to competence*. Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

c. *Participation by those charged with governance*. Attributes of those charged with governance, such as

   i. their independence from management.

   ii. their experience and stature.

   iii. the extent of their involvement and the information they receive and the scrutiny of activities.

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[12] Paragraphs .08–.17 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

iv. the appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management.

v. their interaction with internal and external auditors.

d. *Management's philosophy and operating style*. Characteristics such as management's

i. approach to taking and managing business risks.

ii. attitudes and actions toward financial reporting.

iii. attitudes toward information processing and accounting functions and personnel.

e. *Organizational structure*. The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

f. *Assignment of authority and responsibility*. Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.

g. *Human resource policies and practices*. Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A80 *Audit evidence for elements of the control environment*. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures, such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees management's views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A81 The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented and whether they have been subsequently evaluated by the internal audit function. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A82 *Effect of the control environment on the assessment of the risks of material misstatement*. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance because one of their roles is to counterbalance pressures on management regarding financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment with regard to participation by those charged with governance is therefore influenced by such matters as

- their independence from management and their ability to evaluate the actions of management.
- whether they understand the entity's business transactions.

- the extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A83 An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A84 The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, particularly with regard to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or data or unauthorized transactions to be processed. As explained in section 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.[13] [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A85 The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and, thereby, the auditor's assessment of the risks of material misstatement. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A86 *Considerations specific to smaller, less complex entities*. The control environment within smaller entities is likely to differ from larger entities. For example, those charged with governance in smaller entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager when no other owners exist. The nature of the control environment also may influence the significance of other controls or their absence. For example, the active involvement of an owner-manager may mitigate certain risks arising from a lack of segregation of duties in a small entity; however, it may increase other risks (for example, the risk of override of controls). [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A87 In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular when communication between management and other personnel may be informal, yet effective. For example, smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

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[13] Paragraph .A2 of section 330. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

.A88 Consequently, the attitudes, awareness, and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Components of Internal Control—The Entity's Risk Assessment Process (Ref: par. .16)

.A89 An entity's risk assessment process for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation and fair presentation of financial statements. If that process is appropriate to the circumstances, including the nature, size, and complexity of the entity, it assists the auditor in identifying risks of material misstatement. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of professional judgment. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A90 Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances such as the following:

- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New business models, products, or activities
- Corporate restructurings
- Expanded foreign operations
- New accounting pronouncements
- Changes in economic conditions

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A91 *Considerations specific to smaller, less complex entities (Ref: par. 18).* A smaller entity is unlikely to have an established risk assessment process in place. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Components of Internal Control—The Information System, Including the Related Business Processes Relevant to Financial Reporting and Communication

.A92 *The information system, including related business processes relevant to financial reporting (Ref: par. .19).* The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to

- initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and maintain accountability for the related assets, liabilities, and equity;

- resolve incorrect processing of transactions (for example, automated suspense files and procedures followed to clear suspense items out on a timely basis);
- process and account for system overrides or bypasses to controls;
- transfer information from transaction processing systems to the general ledger;
- capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A93 *Journal entries*. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A94 An entity's financial reporting process also includes the use of nonstandard journal entries to record nonrecurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or nonrecurring estimates, such as the impairment of an asset. In manual general ledger systems, nonstandard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may, therefore, be more easily identified through the use of computer assisted audit techniques. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A95 *Related business processes*. An entity's business processes are the activities designed to

- develop, purchase, produce, sell, and distribute an entity's products and services;
- ensure compliance with laws and regulations; and
- record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed, and reported by the information system. Obtaining an understanding of the entity's business processes, which includes how transactions are originated, assists the auditor to obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A96 *Considerations specific to smaller, less complex entities*. Information systems and related business processes relevant to financial reporting in smaller entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Smaller entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may, therefore, be easier in an audit of smaller entities, and it may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A97 *Communication (Ref: par. .20).* Communication by the entity of the financial reporting roles and responsibilities and significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A98 *Considerations specific to smaller, less complex entities.* Communication may be less structured and easier to achieve in a smaller entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Components of Internal Control—Control Activities (Ref: par. .21)

.A99 Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

- Authorization
- Performance reviews
- Information processing
- Physical controls
- Segregation of duties

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A100 Control activities that are relevant to the audit are those that are

- required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs .30–.31, respectively, or
- considered to be relevant in the professional judgment of the auditor.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A101 The auditor's professional judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A102 The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas in which the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A103 The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A104 *Considerations specific to smaller, less complex entities*. The concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A105 Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles, such as revenues, purchases, and employment expenses. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A106 *Risks arising from IT (Ref: par. .22)*. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process and when they include effective general IT controls and application controls. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A107 *General IT controls* are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations
- System software acquisition, change, and maintenance
- Program change
- Access security
- Application system acquisition, development, and maintenance

They are generally implemented to deal with the risks referred to in paragraph .A64. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A108 Although ineffective general IT controls do not by themselves cause misstatements, they may permit application controls to operate improperly and allow misstatements to occur and not be detected. For example, if deficiencies in the general IT controls over access security exist and applications are relying on these general controls to prevent unauthorized transactions from being processed, such general IT control deficiencies may have a more severe effect on the effective design and operation of the application control. General IT controls are assessed with regard to their effect on applications and data that become part of the financial statements. For example, if no new systems are implemented during the period of the financial statements, deficiencies in the general IT controls over application system acquisition and development may not be relevant to the financial statements being audited. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A109 *Application controls* are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, authorize, record, process, and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Components of Internal Control—Monitoring of Controls (Ref: par. .23)

.A110 Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities often are built into the normal recurring activities of an entity and include regular management and supervisory activities. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A111 *Considerations specific to smaller, less complex entities*. Management's monitoring of controls often is accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A112 *Internal audit function (Ref: par. .24)*. If the entity has an internal audit function, obtaining an understanding of that function contributes to the external auditor's understanding of the entity and its environment, including internal control; this also includes the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the external auditor's inquiries in paragraph .06*a*, may also provide information that is directly relevant to the external auditor's identification and assessment of the risks of material misstatement. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A113 The entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing or reduce the extent of audit procedures to be performed. If the auditor determines that the internal audit function is likely to be relevant to the audit, section 610, *Using the Work of Internal Auditors*, applies. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A114 The objectives and scope of an internal audit function and therefore, the nature of its responsibilities and its status within the organization, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and those charged with governance. These matters may be set out in an internal audit charter or terms of reference. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A115 The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control, and governance processes. The internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency, and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A116 The external auditor's inquiries of appropriate individuals within the internal audit function, in accordance with paragraph .06*a*, help the external auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the external auditor determines that the function's responsibilities are related to the entity's financial reporting, the external auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A117 If the nature of the internal audit function's responsibilities and assurance activities is related to the entity's financial reporting, the external auditor may be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor in obtaining audit evidence. External auditors may be more likely to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the external auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations and has a direct reporting relationship to those charged with governance. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A118 If, based on the external auditor's preliminary understanding of the internal audit function, the external auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, section 610 applies. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A119 As is further discussed in section 610, the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A120 Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the external auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the external auditor. Section 200 addresses the importance of the external auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the external auditor's attention. The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A121 *Sources of information (Ref: par. .25).* Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of the following is required as part of the auditor's understanding of the entity's monitoring activities component of internal control:

- The sources of the information related to the entity's monitoring activities
- The basis upon which management considers the information to be sufficiently reliable for the purpose

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: par. .26a)

.A122 Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level (for example, through management override of internal control). Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A123 Risks at the financial statement level may derive, in particular, from a deficient control environment (although these risks also may relate to factors such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A124 The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example

- concerns about the integrity of the entity's management may be so serious to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A125 Section 705, *Modifications to the Opinion in the Independent Auditor's Report*, addresses the determination of whether a need exists for the auditor to express a qualified or adverse opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement when withdrawal is possible under applicable law or regulation. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Assessment of Risks of Material Misstatement at the Relevant Assertion Level (Ref: par. .26b)

.A126 Risks of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the relevant assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many relevant assertions. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

The Use of Assertions

.A127 In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A128 Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

a. Assertions about classes of transactions and events for the period under audit, such as the following:

  i. *Occurrence*. Transactions and events that have been recorded have occurred and pertain to the entity.

  ii. *Completeness*. All transactions and events that should have been recorded have been recorded.

  iii. *Accuracy*. Amounts and other data relating to recorded transactions and events have been recorded appropriately.

  iv. *Cutoff*. Transactions and events have been recorded in the correct accounting period.

  v. *Classification*. Transactions and events have been recorded in the proper accounts.

b. Assertions about account balances at the period-end, such as the following:

i. *Existence*. Assets, liabilities, and equity interests exist.

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

iii. *Completeness*. All assets, liabilities, and equity interests that should have been recorded have been recorded.

iv. *Valuation and allocation*. Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded.

c. Assertions about presentation and disclosure, such as the following:

i. *Occurrence and rights and obligations*. Disclosed events, transactions, and other matters have occurred and pertain to the entity.

ii. *Completeness*. All disclosures that should have been included in the financial statements have been included.

iii. *Classification and understandability*. Financial information is appropriately presented and described, and disclosures are clearly expressed.

iv. *Accuracy and valuation*. Financial and other information is disclosed fairly and in appropriate amounts.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A129 The auditor may use the assertions as described previously or may express them differently, provided that all aspects described previously have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. As another example, there may not be a separate assertion related to cutoff of transactions and events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Relevant Assertions

.A130 The auditor is required by paragraph .26*b* to use relevant assertions for classes of transactions, account balances, and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor also is required to use relevant assertions in assessing risks by relating the identified risks to what can go wrong at the relevant assertion, taking account of relevant controls that the auditor intends to test, and designing further audit procedures that are responsive to the assessed risks. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A131 *Relevant assertions* are assertions that have a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated and, as such, are assertions that have a meaningful bearing on whether the account is fairly stated. Not all assertions pertaining to a particular account balance will always be relevant. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance but is relevant to the related allowance accounts.

Additionally, the auditor might, in some circumstances, focus on the presentation and disclosure assertions separately in connection with the period-end financial reporting process. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A132 For each significant class of transactions, account balance, and disclosure, the auditor is required to determine the relevance of each of the financial statement assertions. Identifying relevant assertions includes determining the source of likely potential misstatements in each significant class of transactions, account balance, and disclosure. Attributes indicating the potential relevance of an assertion include the

a. nature of the assertion;

b. volume of transactions or data related to the assertion; and

c. nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Considerations Specific to Governmental Entities

.A133 When making assertions about the financial statements of governmental entities, in addition to those assertions set out in paragraph .A128, management asserts that transactions and events have been carried out in accordance with law or regulation. Such assertions may fall within the scope of the financial statement audit. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Process of Identifying Risks of Material Misstatement (Ref: par. .27a)

.A134 Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A135 Appendix C provides examples of conditions and events that may indicate the existence of risks of material misstatement. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Relating Controls to Assertions (Ref: par. .27c)

.A136 In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A137 Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A138 Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Significant Risks

Identifying Significant Risks (Ref: par. .28–.29)

.A139 Significant risks often relate to significant nonroutine transactions and matters that require significant judgment. *Nonroutine transactions* are transactions that are unusual, either due to size or nature, and that, therefore, occur infrequently. Matters that require significant judgment may include the development of accounting estimates for which a significant measurement uncertainty exists. Routine, noncomplex transactions that are subject to systematic processing are less likely to give rise to significant risks. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A140 Risks of material misstatement may be greater for significant nonroutine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment
- Greater manual intervention for data collection and processing
- Complex calculations or accounting principles
- The nature of nonroutine transactions, which may make it difficult for the entity to implement effective controls over the risks
- Related party transactions

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A141 Risks of material misstatement may be greater for matters that require significant judgment, such as the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex or it may require assumptions about the effects of future events (for example, judgment about fair value).

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A142 Section 330 describes the consequences for further audit procedures of identifying a risk as significant.[14] [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Significant Risks Relating to the Risks of Material Misstatement Due to Fraud

.A143 Section 240 further addresses the identification and assessment of the risks of material misstatement due to fraud. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Understanding Controls Related to Significant Risks (Ref: par. .30)

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[14] Paragraphs .15 and .22 of section 330. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

.A144 Although risks relating to significant nonroutine transactions or matters that require significant judgment are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from nonroutine transactions or matters that require significant judgment includes whether and how management responds to the risks. Such responses might include

- control activities, such as a review of assumptions by senior management or specialists.
- documented processes for estimations.
- approval by those charged with governance.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A145 For example, when nonrecurring events occur, such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate specialists (for example, internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A146 In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls may be a significant deficiency or a material weakness. In these circumstances, the auditor also may consider the implications for the auditor's risk assessment. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: par. .31)

.A147 Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions, such as an entity's revenue; purchases; and cash receipts or cash payments. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A148 When such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures regarding the risk. For example, the auditor may consider this to be the case when a significant amount of an entity's information is initiated, authorized, recorded, processed, or reported only in electronic form, such as in an integrated system. In such cases

- audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- the potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A149 Examples of situations in which the auditor may find it impossible to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence that certain relevant assertions are not materially misstated include the following:

- An entity that conducts its business using IT to initiate orders for the purchase and delivery of goods based on predetermined rules of what to order and in what quantities and to pay the related accounts payable based on system-generated decisions initiated upon the confirmed receipt of goods and terms of payment. No other documentation of orders placed or goods received is produced or maintained, other than through the IT system.
- An entity that provides services to customers via electronic media (for example, an Internet service provider or a telecommunications company) and uses IT to create a log of the services provided to its customers, initiate and process its billings for the services, and automatically record such amounts in electronic accounting records that are part of the system used to produce the entity's financial statements.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A150 The consequences for further audit procedures of identifying such risks are described in section 330.[15] [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Revision of Risk Assessment (Ref: par. .32)

.A151 During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that controls are operating effectively. In performing tests of controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures, the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessment. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity, and the further planned audit procedures may not be effective in detecting material misstatements. See section 330 for further guidance. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

Documentation (Ref: par. .33)

.A152 The manner in which the requirements of paragraph .33 are documented is for the auditor to determine exercising professional judgment. For example, in audits of smaller entities, the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.[16] Similarly, the results of the risk assessment may be documented separately, or they may be documented as part of the auditor's documentation of further audit procedures.[17] The form and extent of the documentation is influenced by the nature, size, and complexity of the entity and its internal control; availability of information from the entity; and the audit methodology and technology used in the course of the audit. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A153 For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple and relatively

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[15] Paragraph .08 of section 330. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

[16] Paragraphs .07–.09 of section 300, *Planning an Audit*. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

[17] Paragraph .30 of section 330. [Footnote renumbered by the issuance of SAS No. 128, January 2015.]

brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A154 The extent of documentation also may reflect the experience and capabilities of the members of the audit engagement team. Provided that the requirements of section 230, *Audit Documentation*, are met, an audit undertaken by an engagement team comprising less experienced individuals may contain more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A155 For recurring audits, certain documentation may be carried forward and updated as necessary to reflect changes in the entity's business or processes. [Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A156

Appendix A—Understanding the Entity and Its Environment (Ref: par. .A24)

This appendix provides additional guidance on matters the auditor may consider when obtaining an understanding of the industry and regulatory and other external factors that affect the entity, the nature of the entity, objectives and strategies and related business risks, and the measurement and review of the entity's financial performance. The examples provided cover a broad range of matters applicable to many engagements; however, not all matters are relevant to every engagement, and the list of examples is not necessarily complete. Additional guidance on internal control is contained in appendix B, "Internal Control Components."

Industry, Regulatory, and Other External Factors

Examples of matters an auditor may consider include the following:

- Industry conditions, such as the following:
  - — The market and competition, including demand, capacity, and price competition
  - — Cyclical or seasonal activity
  - — Product technology relating to the entity's products
  - — Supply availability and cost
- Regulatory environment, such as the following:
  - — Accounting principles and industry-specific practices
  - — Regulatory framework for a regulated industry
  - — Legislation and regulation that significantly affect the entity's operations, such as the following:
    - Regulatory requirements
    - Direct supervisory activities
  - — Taxation (corporate and other)
  - — Government policies currently affecting the conduct of the entity's business, such as the following:
    - Monetary, including foreign exchange controls
    - Fiscal
    - Financial incentives (for example, government aid programs)
    - Tariffs and trade restrictions
  - — Environmental requirements affecting the industry and the entity's business
- Other external factors currently affecting the entity's business, such as the following:
  - — General level of economic activity (for example, recession, growth, and so on)
  - — Interest rates and availability of financing
  - — Inflation and currency revaluation

Nature of the Entity

Examples of matters an auditor may consider include the following:

- Business operations, such as the following:
  - — Nature of revenue sources (for example, manufacturer; wholesaler; banking, insurance, or other financial services; import-export trading; utility; transportation; and technology products and services)
  - — 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, backlog, trends, marketing strategy and objectives, and manufacturing processes)
  - — Conduct of operations (for example, stages and methods of production, subsidiaries or divisions, delivery of products and services, and details of declining or expanding operations)
  - — Alliances, joint ventures, and outsourcing activities
  - — Involvement in e-commerce, including Internet sales and marketing activities
  - — Geographic dispersion and industry segmentation
  - — Location of production facilities, warehouses, and offices
  - — Key customers
  - — Important suppliers of goods and services (for example, long term contracts, stability of supply, terms of payment, imports, and methods of delivery, such as "just-in-time")
  - — Employment (for example, by location, supply, wage levels, union contracts, pension and other postemployment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters)
  - — Research and development activities and expenditures
  - — Transactions with related parties

- Investments, such as the following:
  - — Acquisitions, mergers, or disposals of business activities (planned or recently executed)
  - — Investments and dispositions of securities and loans
  - — Capital investment activities, including investments in plant and equipment and technology and any recent or planned changes
  - — Investments in nonconsolidated entities, including partnerships, joint ventures, and investments in entities formed to accomplish specific objectives
  - — Life cycle stage of enterprise (start-up, growing, mature, declining)

- Financing, such as the following:
  - — Group structure of major subsidiaries and associated entities, including consolidated and nonconsolidated structures
  - — Debt structure, including covenants, restrictions, guarantees, and off balance sheet financing arrangements
  - — Leasing of property, plant, or equipment for use in the business
  - — Beneficial owners (local and foreign business reputation and experience)
  - — Related parties
  - — Use of derivative financial instruments
- Financial reporting, such as the following:
  - — Accounting principles and industry-specific practices
  - — Revenue recognition practices
  - — Accounting for fair values
  - — Inventories (for example, locations and quantities)
  - — Foreign currency assets, liabilities, and transactions
  - — Industry-specific significant categories (for example, loans and investments for banks, accounts receivable and inventory for manufacturers, research and development for pharmaceuticals)
  - — Accounting for unusual or complex transactions, including those in controversial or emerging areas (for example, accounting for stock-based compensation)
  - — Financial statement presentation and disclosure

Objectives and Strategies and Related Business Risks

Examples of matters an auditor may consider include the following:

- Existence of objectives (that is, how the entity addresses industry, regulatory, and other external factors) relating to, for example, the following matters:
  - — Industry developments (a potential related business risk might be, for example, the entity does not have the personnel or expertise to deal with the changes in the industry)
  - — New products and services (a potential related business risk might be, for example, product liability has increased)
  - — Expansion of the business (a potential related business risk might be, for example, the demand has not been accurately estimated)
  - — New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation or increased costs)
  - — Regulatory requirements (a potential related business risk might be, for example, legal exposure has increased)

  - — Current and prospective financing requirements (a potential related business risk might be, for example, the entity's inability to meet requirements results in the loss of financing)
  - — IT (a potential related business risk might be, for example, systems and processes are not compatible)
  - — Risk appetite of managers and stakeholders
- Effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, implementation is incomplete or improper)

Measurement and Review of the Entity's Financial Performance

Examples of matters an auditor may consider include the following:

- Key ratios and operating statistics
- Key performance indicators
- Employee performance measures and incentive compensation policies
- Trends
- Use of forecasts, budgets, and variance analysis
- Analyst reports and credit rating reports
- Competitor analysis
- Period-on-period financial performance (revenue growth, profitability, and leverage)

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A157

Appendix B—Internal Control Components (Ref: par. .04, .15–.25, and .A78–.A121)

This appendix further explains the components of internal control, as set out in paragraphs .04, .15–.25, and .A78–.A121, as they relate to a financial statement audit.

Control Environment

The control environment encompasses the following elements:

a. *Communication and enforcement of integrity and ethical values*. The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the products of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

b. *Commitment to competence*. *Competence* is the knowledge and skills necessary to accomplish tasks that define the individual's job.

c. *Participation by those charged with governance*. An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle-blower procedures and the process for reviewing the effectiveness of the entity's internal control.

d. *Management's philosophy and operating style*. Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles or conscientiousness and conservatism with which accounting estimates are developed.

e. *Organizational structure*. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

f. *Assignment of authority and responsibility*. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

g. *Human resource policies and practices*. Human resource policies and practices often demonstrate important matters regarding the control consciousness of an entity. For example, standards for recruiting the most qualified individuals, with an emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior, demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

The Entity's Risk Assessment Process

For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation and fair presentation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.

Risks relevant to reliable financial reporting include external and internal events, as well as transactions or circumstances that may occur and adversely affect an entity's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment*. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel*. New personnel may have a different focus on, or understanding of, internal control.
- *New or revamped information systems*. Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth*. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology*. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities*. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.

- *Corporate restructurings*. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations*. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control (for example, additional or changed risks from foreign currency transactions).
- *New accounting pronouncements*. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

The Information System, Including the Related Business Processes Relevant to Financial Reporting and Communication

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of IT.

The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that

- identify and record all valid transactions.
- describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- present properly the transactions and related disclosures in the financial statements.

The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- *Performance reviews*. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior-period performance; relating different sets of data (operating or financial) to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

- *Information processing*. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records; maintaining and reviewing accounts and trial balances; automated controls, such as edit checks of input data and numerical sequence checks; and manual follow-up of exception reports. Examples of general IT controls are program change controls; controls that restrict access to programs or data; controls over the implementation of new releases of packaged software applications; and controls over system software that restrict access to, or monitor the use of, system utilities that could change financial data or records without leaving an audit trail.
- *Physical controls*. This includes controls that encompass the
  - — physical security of assets, including adequate safeguards, such as secured facilities over access to assets and records.
  - — authorization for access to computer programs and data files.
  - — periodic counting and comparison with amounts shown on control records (for example comparing the results of cash, security, and inventory counts with accounting records).

  The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation and, therefore, the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.
- *Segregation of duties*. Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, nonroutine transactions, such as major acquisitions or divestments, may require specific high level approval, including, in some cases, that of shareholders.

Monitoring of Controls

An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring also is done to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control; communicate information about strengths and deficiencies in internal control; and provide recommendations for improving internal control.

Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control (for example, communications concerning examinations by bank regulatory agencies). Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]

.A158

Appendix C—Conditions and Events That May Indicate Risks of Material Misstatement (Ref: par. .A40 and .A135)

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement, and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable (for example, countries with significant currency devaluation or highly inflationary economies)
- Operations exposed to volatile markets (for example, futures trading)
- Operations that are subject to a high degree of complex regulation
- Going concern and liquidity issues, including loss of significant customers
- Constraints on the availability of capital and credit
- Changes in the industry in which the entity operates
- Changes in the supply chain
- Developing or offering new products or services or moving into new lines of business
- Expanding into new locations
- Changes in the entity, such as large acquisitions or reorganizations or other unusual events
- Entities or business segments likely to be sold
- The existence of complex alliances and joint ventures
- Use of off balance sheet finance, investments in entities formed to accomplish specific objectives, and other complex financing arrangements
- Significant transactions with related parties
- Lack of personnel with appropriate accounting and financial reporting skills
- Changes in key personnel, including departure of key executives
- Deficiencies in internal control, especially those not addressed by management
- Inconsistencies between the entity's IT strategy and its business strategies
- Changes in the IT environment
- Installation of significant new IT systems related to financial reporting
- Inquiries into the entity's operations or financial results by regulatory or government bodies

- Past misstatements, history of errors, or a significant amount of adjustments at period-end
- Significant amount of nonroutine or nonsystematic transactions, including intercompany transactions and large revenue transactions at period-end
- Transactions that are recorded based on management's intent (for example, debt refinancing, assets to be sold, and classification of marketable securities)
- Application of new accounting pronouncements
- Accounting measurements that involve complex processes
- Events or transactions that involve significant measurement uncertainty, including accounting estimates
- Pending litigation and contingent liabilities (for example, sales warranties, financial guarantees, and environmental remediation)

[Paragraph renumbered by the issuance of SAS No. 128, January 2015.]