COMMENTS AND OBSERVATIONS TO BE SENT TO :beukaegbu@ican.org.ng

Technical Guidance

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Assurance Engagement to Report on Internal Control over Financial Reporting

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About ICAN

Established by the Act of Parliament No. 15 of 1965, the Institute of Chartered Accountants of Nigeria (ICAN) is statutorily empowered to set standards and regulate the practice of Accountancy in Nigeria.

As a member of the International Federation of Accountants (IFAC), it is a part of ICAN's responsibility to adapt and adopt standards issued by global body for use in Nigeria.

This guidance is issued by the Institute in pursuance of its statutory responsibility and in fulfillment of its membership obligation to IFAC.

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Background to the issuance of this guidance

In 2007, the Investment and Securities Act (the "Act") was passed into law. The law, among other things, established new provisions related to reporting on internal controls including internal controls over financial reporting. Section 61 of the Act require public companies to establish a system of internal controls over their financial reporting and security of their assets and place the responsibility to ensure the integrity of companies financial controls and reporting on boards of directors. That section also required the board of directors of a public company to report on the effectiveness of the company's internal control system in its annual report. Section 63 states that an auditor of a public company shall, in his audit report to the company, issue a statement as to the existence, adequacy and effectiveness or otherwise of the internal control system of the public company. Section 7 (f) of Part 1 of Financial Reporting Act of 2011 requires management assessment of internal controls, including Information Systems controls with independent attestation

In addition to these regulatory provisions, the Securities and Exchange Commission (SEC) and the Central Bank of Nigeria (CBN) have issued codes of corporate governance that charge those responsible for corporate governance to ensure the development of a comprehensive framework for internal controls and risk management, to obtain assurance on those controls and to report on these or cause required reports to be issued.

Reporters and practitioners are unable to comply with these requirements as no guidance has been issued by any regulator on how the needed assessments should be made, the applicable framework for management's assessment of the operating effectiveness of controls and practices, or and the procedures to be followed by practitioners in conducting their reviews of these management assessments. Accordingly, no meaningful reports have been made to any regulator in compliance with these statutory directives despite various reminders by the regulators.

This guidance has been written for assurance practitioners (including those serving as auditors) who will undertake to express a conclusion on management's assessment of internal control over financial reporting.

The objective of **this guidance** is to assist practitioners in designing, planning, performing and reporting upon an assurance engagement on controls over financial reporting. Assurance can give the user a view as to the reliability of the information. It cannot be a substitute for clear rules and guidance concerning the reporting of information by reporters, and others with clearly delineated responsibilities. Without such clarity, there will always be the risk of an expectation gap between preparers, practitioners and users of the information which in turn is likely to impact market confidence.

The role of the assurance practitioner is to assess whether the information reported or assertion made is supported by the available evidence, whether this is the operating

effectiveness of controls in meeting control objectives, or the fair statement of the organisation as to their compliance with a set of principles. Where insufficient evidence exists this may impact acceptance of an engagement or result in a qualified assurance conclusion. Practitioners do not assume the responsibilities of the reporting party or the party who created the rules and guidance for the assessment. Nor do practitioners determine the correct interpretation of ambiguous rules or guidance, although practitioners consider whether the interpretation applied is clear and available to the reader of the assurance report.

The guidance may also be of interest to:

- Directors of companies and institutions, and audit committee members which contribute to overall companies internal control assessment.
- Compilers and publishers of controls reporting standards.
- Regulators and government agencies interested in, or responsible for market security and corporate governance.

This guidance is modelled after the Auditing Standard 5 issued by the United States Public Company Accounting Oversight Board (PCAOB) and significantly leverages the following information sources:

- PCAOB's Auditing Standard No 5 , Release No 2007-005A;
- ICAEW Technical Release on Assurance Reports on benchmarks and indices (TECH02/14FSF);
- International Standards on Auditing (ISA);
- International Standard on Assurance Engagements 3000;
- U. S Securities and Exchange Commission (US SEC) Rules and Regulations;
- Bank and Other Financial Institutions Act (BOFIA);
- Investment and Securities Act 2007;

This guidance is available for immediate use by practitioners. Practitioners are encouraged to share comments that will arise from their application of **this guidance**. All comments received from practitioners from their application of **this guidance** will be considered in developing future releases for reporting on internal controls over financial reporting.

A separate guidance *'Guidance Regarding Management's Evaluation and Assessment Report on Internal Control over Financial Reporting'* has been issued by SEC to be used by management for assessing internal controls over financial reporting.

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Introduction

1. **This guidance** establishes requirements and provides direction that applies when a practitioner is required to perform an engagement to report on **management's assessment** of the effectiveness of **internal control over financial reporting** ("the assurance engagement of internal control over financial reporting"). A public company whose securities are required to be registered under the Investment and Securities Act shall file with the Commission on a periodic or annual basis, its audited financial statements and such other returns as may be prescribed by the Commission from time to time.

   Notes: Management's assessment of the effectiveness of the entity's internal control over financial reporting should be as of the end of the company's most recent fiscal year, and must include a statement as to whether or not internal control over financial reporting is effective. This assessment must include disclosure of any material weakness in the entity's internal control over financial reporting identified by management. Management is not permitted to conclude that the entity's internal control over financial reporting is effective if there are one or more material weaknesses in the entity's internal control over financial reporting.

   A limited assurance is an assurance engagement, in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated. The nature, timing, and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement but is planned to obtain a level of assurance that is, in the practitioner's professional judgment, meaningful. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential. (International Standards on Assurance Engagements (ISAE) 3000 Revised- Assurance Engagements other than Audits or Reviews of Historical Financial Information).

   A public company is as defined in the Companies and Allied Matters Act.

   See definitions in Appendix 1.

2. The chief executive officer and the chief financial officer or officers or persons

performing similar functions in a public company filing periodic or annual reports under (1) above shall certify in each annual or periodic report filed that the signing officers;

a. are responsible for establishing and maintaining internal controls over financial reporting;
b. have designed such internal controls to ensure that material information relating to the company and to its consolidated subsidiaries is made known to such officers by others within those entities particularly during the period in which the periodic reports are being prepared;
c. Have evaluated the effectiveness of the company's internal controls over financial reporting as of 90 days prior to the report;
d. Have presented in the report their conclusions about the effectiveness of their internal controls over financial reporting based on their evaluation as of that date;
e. The signing officers have disclosed to the auditors of the company and audit committee all significant deficiencies (see definition in Appendix A, para 11) in the design or operation of internal controls over financial reporting which would adversely affect the company's ability to record, process or summarize and report financial data and have identified for the company's auditors any material weakness (see definition in Appendix A7) in internal controls over financial reporting;
f. Have evaluated any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls over financial reporting; and
g. The signing officers have indicated in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weakness.

3. Effective internal control over financial reporting provides assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. If one or more material weaknesses exist, the company's internal control over financial reporting cannot be considered effective.

4. The practitioner's objective in an assurance engagement to report on internal control over financial reporting is to issue an assurance report on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an assurance conclusion, the practitioner must plan and perform the assurance engagement to obtain competent evidence that is sufficient to obtain assurance about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over financial

reporting may exist even when financial statements are not materially misstated.

5. This general guidance is applicable to an assurance engagement to report on internal control over financial reporting. The guidance requires technical training and proficiency as a practitioner, independence, and the exercise of due professional care, including professional skepticism. The guidance establishes the fieldwork and reporting standards applicable to an assurance engagement to report on internal control over financial reporting. See description below for this general standard.

Note: General Standards

1. The assurance engagement is to be performed by a person or persons having adequate technical training and proficiency as a practitioner.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the practitioner or practitioners.
3. Due professional care is to be exercised in the performance of the assurance engagement and the preparation of the report.

Standards on Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the assurance engagement and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient appropriate evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether management's evaluation are presented in accordance with a recognized control framework.
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in management's evaluation of internal controls over financial reporting are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of a conclusion regarding management's evaluation, taken as a whole, or an assertion to the effect that a conclusion cannot be expressed. When an overall opinion cannot be expressed, the reasons thereof should be stated. In all cases where a practitioner's name is associated with the assurance report on internal controls over financial reporting, the report should contain a clear-cut indication of the character of the practitioner's work, if any, and the degree of responsibility the practitioner is taking.

5. Shall consider information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

6. The practitioner should use the same suitable, recognized control framework to perform his or her assurance engagement to report on internal control over financial reporting as management uses for its periodic/annual evaluation of the effectiveness of the company's internal control over financial reporting. This standard requires management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. See further information below.

Notes: SEC has issued guidance for management in performing their assessment of internal control over financial reporting. This guidance requires management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. The report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework and SEC recommends it's use as the most appropriate internal control framework for Nigerian businesses.

Planning the Assurance Engagement

7. The practitioner should properly plan the assurance engagement to report on internal control over financial reporting and properly supervise any assistants. When planning a assurance engagement to report on internal controls over financial reporting the practitioner should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting respectively and, if so, how they will affect the practitioner's procedures:

   a. Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the practitioner;
   b. Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
   c. Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
   d. The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
   e. The practitioner's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;

f. Control deficiencies previously communicated to the audit committee (and/or board of directors if there is no audit committee) or management;

g. Legal or regulatory matters of which the company is aware;

h. The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;

i. Preliminary judgments about the effectiveness of internal control over financial reporting;

j. Public information about the company relevant to the evaluation of the effectiveness of the company's internal control over financial reporting;

k. Knowledge about risks related to the company evaluated as part of the practitioner's client acceptance and retention evaluation; and

l. The relative complexity of the company's operations.

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

The term "senior management" includes the principal executive and financial officers signing the company's financial reports or as required under Section 60 of the Investments and Securities Act 2007 as well as any other members of senior management who play a significant role in the company's financial reporting process.

Role of Risk Assessment

8. Risk assessment underlies the entire assurance engagement process described by this standard, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control.

Note: Risk assessment or the top down risk assessment (TDRA) is a financial risk assessment performed by management and the practitioner. It is used by management to determine the scope and required evidence to support management's testing of internal controls over financial reporting. It is used by the practitioner to issue a formal conclusion on the entity's internal controls over financial reporting.

9. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to

prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The practitioner should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

10. The complexity of the organization, business unit, or process, will play an important role in the practitioner's risk assessment and the determination of the necessary procedures.

Scaling the Assurance engagement on Internal Control over Financial Reporting

11. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and is applicable to the review of internal control over financial reporting of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.

Addressing the Risk of Fraud

12. When planning and performing the assurance engagement to report on internal control over financial reporting, the practitioner should take into account the results of his or her fraud risk assessment (Appendix E). As part of identifying and testing entity-level controls, as discussed beginning at paragraph 20, and selecting other controls to test, as discussed beginning at paragraph 36, the practitioner should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include:

    a. Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
    b. Controls over journal entries and adjustments made in the period-end financial reporting process;
    c. Controls over related party transactions;
    d. Controls related to significant management estimates; and
    e. Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

13. If the practitioner identifies deficiencies in controls designed to prevent or detect fraud during the assurance engagement to report on internal control over financial reporting, the practitioner should take into account those deficiencies when the auditor is developing his or her response to risks of material misstatement during the financial statement audit.

Using the Work of Others

14. The practitioner should evaluate the extent to which he or she will use the work of others to reduce the work the practitioner might otherwise perform himself or herself. Section 52 – 55 of ISAE 3000 on Assurance Engagements other than Audits or Reviews of Historical Financial Information discusses "Work Performed by a Practitioner's Expert applies in the assurance engagement to report on internal control over financial reporting.

15. For purposes of the assurance engagement to report on internal control over financial reporting, the practitioner may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. The practitioner also may use this work to obtain evidence supporting the practitioner's assessment of control risk for purposes of the assurance engagement on internal control over financial reporting. See Appendix D for further guidance on using the work of internal auditors.

16. The practitioner should assess the competence and objectivity of the persons whose work the practitioner plans to use to determine the extent to which the practitioner may use their work. The higher the degree of competence and objectivity, the greater use the practitioner may make of the work. The practitioner should apply Section 55 of ISAE 3000 to assess the competence and objectivity of internal auditors.

    The practitioner should apply the principles underlying the paragraphs in Section 52 of ISAE 3000 to assess the competence and objectivity of persons other than internal auditors whose work the practitioner plans to use.

> Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the practitioner should evaluate factors about the person's qualifications and ability to perform the work the practitioner plans to use. To assess

objectivity, the practitioner should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the practitioner plans to use. The practitioner should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the practitioner should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the practitioner.

17. The extent to which the practitioner may use the work of others in an assurance engagement to report on internal control over financial reporting also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the practitioner to perform his or her own work on the control increases.

Materiality

18. In planning the assurance engagement on internal control over financial reporting, the practitioner should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements if the practitioner is also the independent auditor to the company and is performing this engagement at the same time as the financial statement audit otherwise the practitioner should define his materiality in accordance with paragraph 44 of ISAE 3000.

Using a Top-Down Approach

19. The practitioner should use a top-down approach to perform the assurance engagement to report on internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the practitioner's understanding of the overall risks to internal control over financial reporting. The practitioner then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the practitioner's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The practitioner then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

Note: The top-down approach describes the practitioner's sequential thought process in identifying risks and the controls to test, not necessarily the order in

which the practitioner will perform the review procedures.

Identifying Entity-Level Controls

20. The practitioner must test those entity-level controls that are important to the practitioner's conclusion about whether the company has effective internal control over financial reporting. The practitioner's evaluation of entity-level controls can result in increasing or decreasing the testing that the practitioner otherwise would have performed on other controls.

21. Entity-level controls vary in nature and precision :

    a. Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

    b. Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.

    c. Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

22. Entity-level controls include:

    a. Controls related to the control environment;
    b. Controls over management override;

    Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight *by* the audit committee that focuses on the risk of

management override.

c. The company's risk assessment process;
d. Centralized processing and controls, including shared service environments;
e. Controls to monitor results of operations;
f. Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
g. Controls over the period-end financial reporting process; and
h. Policies that address significant business control and risk management practices.

23. Control Environment. Because of its importance to effective internal control over financial reporting, the practitioner must evaluate the control environment at the company. As part of evaluating the control environment, the practitioner should assess :

a. Whether management's philosophy and operating style promote effective internal control over financial reporting;

b. Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
c. Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

24. *Period-end Financial Reporting Process*. Because of its importance to financial reporting and to the practitioner's report on internal control over financial reporting, the practitioner must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following:

a. Procedures used to enter transaction totals into the general ledger;
b. Procedures related to the selection and application of accounting policies;
c. Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
d. Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and
e. Procedures for preparing annual and quarterly financial statements and related disclosures.

Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

25. As part of evaluating the period-end financial reporting process, the practitioner should assess:

a. Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
b. The extent of information technology ("IT") involvement in the period-end financial reporting process;
c. Who participates from management;
d. The locations involved in the period-end financial reporting process;
e. The types of adjusting and consolidating entries; and
f. The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

Note: The practitioner should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the practitioner is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

26. The practitioner should identify significant accounts and disclosures and their relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include:

a. Existence or occurrence;
b. Completeness;
c. Valuation or allocation;
d. Rights and obligations;
   - Presentation and disclosure accuracy;
   - Cut off;
   - Classification

Note: Assessment of Risks of Material Misstatement at the Assertion Level

Risks of material misstatement at the 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 procedures at the assertion level necessary to obtain sufficient appropriate evidence. In identifying and assessing risks of material misstatement at the assertion level, the practitioner may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

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

1. Assertions about classes of transactions and events for the period under audit:
   - Occurrence—transactions and events that have been recorded have occurred and pertain to the entity. Completeness—all transactions and events that should have been recorded have been recorded.
   - Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
   - Cutoff—transactions and events have been recorded in the correct accounting period.
   - Classification—transactions and events have been recorded in the proper accounts.

2. Assertions about account balances at the period end:
   - Existence—assets, liabilities, and equity interests exist.
   - Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
   - Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
   - 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.

3. Assertions about presentation and disclosure:

   - Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
   - Completeness—all disclosures that should have been included in the financial statements have been included.
   - Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
   - Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

Note: See ISA 315 paragraph 25(b) 'identifying and assessing the risks of material misstatement through understanding the entity and its environment', which provides additional information on financial statement assertions.

The practitioner may base his or her work on assertions that differ from those in **this guidance** if the practitioner has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

27. To identify significant accounts and disclosures and their relevant assertions, the practitioner should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:
    a. Size and composition of the account;
    b. Susceptibility to misstatement due to errors or fraud;
    c. Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
    d. Nature of the account or disclosure;
    e. Accounting and reporting complexities associated with the account or disclosure;
    f. Exposure to losses in the account;
    g. Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
    h. Existence of related party transactions in the account; and
    i. Changes from the prior period in account or disclosure characteristics.

28. As part of identifying significant accounts and disclosures and their relevant assertions, the practitioner also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The practitioner might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

29. The risk factors that the practitioner should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the assurance engagement to report on internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both types of engagements.

    Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are not determined to be significant accounts and disclosures and relevant assertions. This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (See 29.1 – 29.2 below for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph and ISA 240 paragraph 28 -33 for further discussion about predictability of auditing procedures).

    29.1 If the auditor concludes that the effects of likely misstatements, individually or in the

aggregate, do not cause the financial statements to be materially misstated, he or she should recognize that they could still be materially misstated because of further misstatement remaining undetected. As the aggregate likely misstatements increase, the risk that the financial statements may be materially misstated also increases. The auditor generally reduces this risk of material misstatement in planning the audit by restricting the extent of detection risk he or she is willing to accept for an assertion related to an account balance or a class of transactions. The auditor can reduce this risk of material misstatement by modifying the nature, timing, and extent of planned auditing procedures in performing the audit. (See paragraph .29.3.) Nevertheless, if the auditor believes that such risk is unacceptably high, he or she should perform additional auditing procedures or satisfy himself or herself that the entity has adjusted the financial statements to reduce the risk of material misstatement to an acceptable level.

29.2 An audit of financial statements is a cumulative process; as the auditor performs planned auditing procedures, the evidence obtained may cause him or her to modify the nature, timing, and extent of other planned procedures. As a result of performing auditing procedures or from other sources during the audit, information may come to the auditor's attention that differs significantly from the information on which the audit plan was based. For example, the extent of misstatements detected may alter the judgment about the levels of inherent and control risks, and other information obtained about the financial statements may alter the preliminary judgment about materiality. In such cases, the auditor may need to re-evaluate the auditing procedures he or she plans to apply, based on the revised consideration of audit risk and materiality for all or certain of the account balances or classes of transactions and related assertions.

29.3 Overall Responses to the Risk of Material Misstatement
Judgments about the risk of material misstatement due to fraud have an overall effect on how the assurance engagement is conducted in the following ways:
• Assignment of personnel and supervision. The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement. For example, the auditor may respond to an identified risk of material misstatement due to fraud by assigning additional persons with specialized skill and knowledge, such as forensic and information technology (IT) specialists, or by assigning more experienced personnel to the engagement. In addition, the extent of supervision should reflect the risks of material misstatement due to fraud.
• Accounting principles. The auditor should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.
In this respect, the auditor may have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement
of the financial statements. In developing judgments about the quality of such principles the auditor should consider whether their collective application indicates a bias that may create such a material misstatement of the financial statements.
• Predictability of auditing procedures. The auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed—for example, performing substantive tests of selected account balances and assertions not otherwise tested due to their materiality or risk, adjusting the timing of testing from that otherwise expected, using differing sampling methods, and performing procedures at different locations or at locations on an unannounced basis.

30. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

31. When a company has multiple locations or business units, the practitioner should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements. Having made those determinations, the practitioner should then apply the direction in Appendix B10 –B16 for multiple locations scoping decisions.

Understanding Likely Sources of Misstatement

32. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the practitioner should achieve the following objectives
    - Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;
    - Verify that the practitioner has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;
    - Identify the controls that management has implemented to address these potential misstatements; and
    - Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

33. Because of the degree of judgment required, the practitioner should either perform the procedures that achieve the objectives in paragraph 32 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in ISAE 3000 paragraph 52 – 55 and further discussed in Appendix D.

34. The practitioner also should understand how IT affects the company's flow of transactions. The considerations are the same as for an auditor engaged to audit a set of financial statements. Accordingly, the practitioner should apply guidance in Appendix B ISA 315 18 for *Consideration of Internal Control in a Financial Statement Audit*, which discusses the effect of information technology on internal control over financial reporting and the risks to assess.

    Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant

accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this standard.

35. *Performing Walkthroughs.* Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 32 above In performing a walkthrough, the practitioner follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

In performing a walkthrough, at the points at which important processing procedures occur, the practitioner questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the practitioner to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the practitioner to gain an understanding of the different types of significant transactions handled by the process.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

Selecting Controls to Test

36. The practitioner should test those controls that are important to the practitioner's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

37. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

38. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk

of misstatement to a given relevant assertion rather than on how the control is labeled (e.g. entity-level control, transaction-level control, control activity, monitoring control, preventive control, detective control).

Testing Controls

Testing Design Effectiveness

39. The practitioner should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

    Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the practitioner should evaluate whether those alternative controls are effective.

40. Procedures the practitioner performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

41. The practitioner should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

    Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the practitioner may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

42. Procedures the practitioner performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

43. For each control selected for testing, the evidence necessary to persuade the practitioner that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the practitioner should obtain also increases.

> Note: Although the practitioner must obtain evidence about the effectiveness of controls for each relevant assertion, the practitioner is not responsible for obtaining sufficient evidence to support a conclusion about the effectiveness of each individual control. Rather, the practitioner's objective is to express a limited assurance on the company's overall internal control over financial reporting. This allows the practitioner to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

44. Factors that affect the risk associated with a control include:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

> Note: A less complex company or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the practitioner's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its

control objectives and the IT general controls that are important to the effective operation of those application controls.

- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

45. When the practitioner identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, to be considered effective, an individual control does not necessarily have to operate without any deviation The evidence provided by the practitioner's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the practitioner's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

46. *Nature of Tests of Controls*. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the practitioner might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

47. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain

controls, might provide sufficient evidence about whether the control is effective.

49. *Timing of Tests of Controls*. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year. The practitioner should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

50. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the practitioner determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the practitioner to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an assurance on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the practitioner's control risk assessment, the practitioner should test the design and operating effectiveness of those superseded controls, as appropriate. Appendix B1-B9 provides additional direction in situations where this engagement is performed at the same time (i.e. integrated) with other engagements such as an audit or review engagement on financial statements).

51. *Extent of Tests of Controls*. The more extensively a control is tested, the greater the evidence obtained from that test.

52. *Roll-Forward Procedures*. When the practitioner reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

53. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors:

    a. The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;
    b. The sufficiency of the evidence of effectiveness obtained at an interim date;
    c. The length of the remaining period; and
    d. The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

Special Considerations for Subsequent Years' engagements

54. In subsequent years' engagements, the practitioner should incorporate knowledge obtained during past work performed on the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 43 through 53.

55. Factors that affect the risk associated with a control in subsequent years' engagements include those in paragraph 44 and the following –
    a. The nature, timing, and extent of procedures performed in previous engagements,
    b. The results of the previous years' testing of the control, and
    c. Whether there have been changes in the control or the process in which it operates since the previous engagement.

56. After taking into account the risk factors identified in paragraphs 44 and 55, the additional information available in subsequent years' engagements might permit the practitioner to assess the risk as lower than in the initial year. This, in turn, might permit the practitioner to reduce testing in subsequent years.

57. The practitioner may also use a benchmarking strategy for automated application controls in subsequent years' engagements. Benchmarking is described further beginning at paragraph B28.

58. In addition, the practitioner should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the practitioner might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

59. The practitioner must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the engagement, however, the practitioner is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

60. The severity of a deficiency depends on –
    - Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and
    - The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

61. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

62. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not to, the following –
    a. The nature of the financial statement accounts, disclosures, and assertions involved;
    b. The susceptibility of the related asset or liability to loss or fraud;
    c. The subjectivity, complexity, or extent of judgment required to determine the amount involved;
    d. The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
    e. The interaction of the deficiencies; and
    f. The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the practitioner should determine whether individual control deficiencies that affect the same significant account or disclosure,

relevant assertion, or component of internal control collectively result in a material weakness.

63. Factors that affect the magnitude of the misstatement that might result from deficiency or deficiencies in controls include, but are not limited to, the following:

    a. The financial statement amounts or total of transactions exposed to the deficiency; and
    b. The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

64. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

65. The practitioner should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weaknesses

66. Indicators of material weaknesses in internal control over financial reporting include:

    a. Identification of fraud, whether or not material, on the part of senior management;/
    b. Restatement of previously issued financial statements to reflect the correction of a material misstatement. See International reporting standard - IAS 8 on Accounting Changes and Error Corrections, regarding the correction of a misstatement.
    c. Identification by the practitioner of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and
    d. Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

67. When evaluating the severity of a deficiency, or combination of deficiencies, the Practitioner also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the practitioner determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the practitioner should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

Wrapping-Up

Reporting on the Assurance Engagement

68. The practitioner should form a conclusion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the practitioner's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

69. The practitioner's conclusion should provide an assurance on the effectiveness of internal control over financial reporting.

As part of this evaluation, the practitioner should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

70. After forming a conclusion on the effectiveness of the company's internal control over financial reporting, the practitioner should evaluate the presentation of the elements that management is required, under the ISA or 'other regulators' guidelines, to present in its annual report on internal control over financial reporting.

71. If the practitioner determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the practitioner should follow the direction in Appendix C2.

72. The practitioner may form a conclusion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the practitioner's work. ISAE 3000 paragraph 74, requires a practitioner to express a qualified conclusion in the following circumstances:

- *When, in the practitioner's professional judgment, a scope limitation exists and the effect of the matter could be material (see ISAE 3000 paragraph 66). In such cases, the practitioner shall express a qualified conclusion or a disclaimer of conclusion.*
- *When, in the practitioner's professional judgment, the subject matter information is materially misstated (see ISAE 3000 paragraph* 64). *In such cases, the practitioner shall express a qualified conclusion or adverse*

conclusion.

A scope limitation requires the practitioner to express a qualified conclusion, issue a disclaimer of conclusion or withdraw from the engagement (see Appendix C3-C7).

Obtaining Written Representations

73. In an assurance engagement to report on internal control over financial reporting, the practitioner should obtain written representations from management:

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;
b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;
c. Stating that management did not use the practitioner's procedures performed during the review of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;
d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;
e. Stating that management has disclosed to the practitioner all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the practitioner all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;
f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;
g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 77 and 79 have been resolved, and specifically identifying any that have not; and
h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant

deficiencies and material weaknesses.

74. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement. The practitioner should take appropriate actions, including determining the possible effect on the conclusion in the assurance report. As discussed further in paragraph C3, when the scope of the engagement is limited, the practitioner should either withdraw from the engagement or issue a disclaimer of conclusion. Further, the practitioner should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in the audit of the company's financial statements.

75. Paragraph 50 – 60 and appendices A54–A55 and A136–A138 of ISAE 3000, *Written Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

76. The practitioner must communicate, in writing, to management and the audit committee all material weaknesses identified during the assurance engagement to report on internal control over financial reporting. The written communication should be made prior to the issuance of the practitioner's report on internal control over financial reporting.

77. If the practitioner concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the practitioner must communicate that conclusion in writing to the board of directors.

78. The practitioner also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the assurance engagement that are significant deficiencies and must communicate such deficiencies, in writing, to the audit committee.

79. The practitioner also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the engagement and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the practitioner to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the

organization.

80. The practitioner is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the practitioner communicates deficiencies in internal control over financial reporting of which he or she is aware.

81. Because an assurance engagement on internal control over financial reporting does not provide the practitioner with assurance that he or she has identified all deficiencies less severe than a material weakness, the practitioner should not issue a report stating that no such deficiencies were noted during the engagement.

82. When performing an assurance engagement on internal control over financial reporting, the practitioner may become aware of fraud or possible illegal acts. In such circumstances, the practitioner shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. See paragraphs 39 and 53(2) of SEC Rules, paragraph 29 of BOFIA and paragraphs 357 – 360 of CAMA.

Note: Unless all of those charged with governance are involved in managing the entity, if the practitioner has identified or suspects fraud or illegal acts involving:

1. management;
2. employees who have significant roles in internal control; or
3. others where the fraud results in a material misstatement in the financial statements,

the practitioner shall communicate these matters to those charged with governance on a timely basis. If the practitioner suspects fraud involving management, the practitioner shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of procedures necessary to complete the assurance engagement.

The practitioner shall communicate with those charged with governance any other matters related to fraud that are, in the practitioner's judgment, relevant to their responsibilities.

If the practitioner has identified or suspects a fraud, the practitioner shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the practitioner's professional duty to maintain the confidentiality of client information may preclude such reporting, the practitioner's legal responsibilities may override the duty of confidentiality in some circumstances.

Reporting on Internal Control

83. The practitioner's report on an assurance engagement to report on internal control over financial reporting must include the following elements (See appendix C which provides direction on qualifications to the practitioner's report that are required in certain circumstances.

a. A title that includes the word *independent* and describes the nature of the engagement. E.g. *A limited assurance engagement performed by an Independent practitioner to report on management's assessment of controls over financial reporting*.

b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

c. An identification of management's report on internal control;

d. A statement that the practitioner's responsibility is to provide an assurance report on the company's internal control over financial reporting based on his or her assurance engagement;

e. A definition of internal control over financial reporting as stated in appendix A paragraph A5;

f. A statement that the Assurance engagement was conducted in accordance with the **this Guidance**

g. A statement that **this Guidance** requires that the practitioner plan and perform the limited assurance engagement to report on internal control over financial reporting to obtain limited assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that a limited assurance engagement includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the practitioner considered necessary in the circumstances;

i. A statement that the practitioner believes the procedures performed provides a basis for his or her report on the internal control put in place by management over financial reporting;

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures

may deteriorate;

k. The practitioner's report that nothing has come to his or her attention that the internal control procedures over financial reporting put in place by management are not adequate as of the specified date, based on the control criteria;
l. The manual or printed signature of the practitioner's firm;
m. The city and state from which the auditor's report has been issued; and
n. The date of the assurance report.

The practitioner should issue a report on the assurance engagement to report on internal control over financial reporting separately from reports on other engagements performed for the company by the practitioner. If the practitioner is also the independent external auditor and performs this engagement at the same time as the external audit and is required to or otherwise intends to report on this engagement at the same time as the audit engagement, or include the report on this assurance engagement in the company's annual report he or she should add the following paragraph to the 'Report on other legal requirements section of the auditor's report on the financial statements:

In accordance with the requirements of XYZ Regulator, we performed a limited assurance engagement and reported on management's assessment of the Company's internal control over financial reporting as of December 31, 201x. The work performed was done in accordance with [**this Guidance**], and we have issued a [include nature of conclusion] in our report dated [date of report, which should be the same as the date of the report on the financial statements]. [That report is included in page XX of the financial statements]

The practitioner also should add the following paragraph to the report on internal control over financial reporting –
We also have audited, in accordance with the International Standards on Auditing, the [identify financial statements] of the Company and our report dated [date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting] expressed [include nature of opinion].

Report Date

85. The practitioner should date the assurance report on internal control over financial reporting report no earlier than the date on which the practitioner has obtained sufficient competent evidence to support the practitioner's report. Because the current provisions of ISA and the relevant codes of corporate governance are that this assurance engagement should be performed by the statutory auditors and

submitted along with the company's annual report, the practitioners report should be dated the same day as the audit report on the company's financial statements.

Material Weaknesses

86. Paragraphs 59 through 67 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the practitioner must express an adverse conclusion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement. (See Appendix C paragraph C3 for direction when the scope of the engagement has been limited).

87. When expressing an adverse conclusion on internal control over financial reporting because of a material weakness, the auditor's report must include:
- The definition of a material weakness, as provided in Appendix A, para A7.
- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

Note: If the material weakness has not been included in management's assessment, the report should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

88. The auditor should determine the effect his or her adverse conclusion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

Subsequent Events

89. Changes in internal control over financial reporting or other factors that might

significantly affect internal control over financial reporting might occur subsequent to the date as of which the practitioner performed his assurance engagement on internal control over financial reporting before the date of the practitioner's report. The practitioner should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 73h.

90. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the practitioner's report, the practitioner should inquire about and examine, for this subsequent period, the following :

    a. Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,
    b. Independent practitioner's reports (if other than the company's auditor's) of deficiencies in internal control,
    c. Regulatory agency reports on the company's internal control over financial reporting, and
    d. Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

91. The practitioner might inquire about and examine other documents for the subsequent period. Paragraphs 6 to 17 of ISA 560, *Subsequent Events*, though written for auditors performing audits, provide direction on subsequent events for a financial statement audit that also may be helpful to the practitioner performing am assurance engagement on internal control over financial reporting.

APPENDIX A* – *Definitions

For purposes of this standard, the terms listed below are defined as follows –

A1. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A2. A **deficiency** in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A3. Financial statements and related disclosures refers to a company's financial statements and notes to the financial statements as presented in accordance with applicable generally accepted accounting principles ("GAAP"). References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A4. Internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that –

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and

expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Note: The practitioner's procedures as part of either the review of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.
Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

A5 **Management's assessment** is the assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This assessment must include disclosure of any material weakness in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting. This is included in management's annual report on internal control over financial reporting.

A6. A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a **reasonable possibility** of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in IAS 37 – Provisions, contingent liabilities and contingent assets.

A7. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a

combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A8. A **relevant assertion** is 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 based on inherent risk, without regard to the effect of controls.

A9. An account or disclosure is a **significant account or disclosure** if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

A10. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

A12. **A Limited Assurance engagement**: An assurance engagement in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated. The nature, timing, and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement but is planned to obtain a level of assurance that is, in the practitioner's professional judgment, meaningful. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential. See International Standard on Assurance Engagements (ISAE) 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information" for details of what is required by a practitioner performing a limited assurance engagement.

A13. **A reasonable assurance engagement** is an assurance engagement in which the practitioner reduces engagement risk to an acceptably low level in the circumstances

of the engagement as the basis for the practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria. See International Standard on Assurance Engagements (ISAE) 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information" for details of what is required by a practitioner performing a reasonable assurance engagement. The ISAE 3000 should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAEs.

A14. Regulator is a body or organization or an agency set up to ensure compliance with laws, regulations, and established rules. Regulatory agencies are public authority or government organisation responsible for exercising autonomous authority over some area of human activity in a supervisory capacity with the aim of codifying, enforcing rules and regulations, imposing supervision or oversight for the benefit of the public at large and to enforce standards and safety of the use of public goods.

APPENDIX B – Special Topics

Considerations for performing this assurance engagement at the same time (i.e. integrated) with other engagements such as an audit or review engagement on financial statements.

B1. *Tests of Controls in a Review of Internal Control*. The objective of the tests of controls in a review of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the practitioner's review report on the company's internal control over financial reporting. The practitioner's report relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

B2. To provide a review report on internal control over financial reporting as of a point in time, the practitioner should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To provide an assurance report on internal control over financial reporting taken as a whole, the practitioner must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the practitioner test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of providing a review report on internal control over financial reporting, the practitioner should incorporate the results of any additional tests of controls performed to achieve the objective related to providing a review report on the financial statements, as discussed in the following section.

B4. *Tests of Controls in an Audit of Financial Statements*. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the practitioner also should evaluate the results of any additional tests of controls performed by the practitioner to achieve the objective related to providing a review report on the company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. *Effect of Tests of Controls on Substantive Procedures*. If, during the assurance engagement on internal control over financial reporting, the practitioner identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to provide a review report on internal control over financial reporting does not diminish this requirement.

B8. *Effect of Substantive Procedures on the Practitioner's Conclusions about the Operating Effectiveness of Controls*. In an assurance engagement on internal control over financial reporting, the practitioner should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum –

- The practitioner's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the practitioner's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the practitioner's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B10. In determining the locations or business units at which to perform tests of controls, the practitioner should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

Note: The practitioner may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.

B11. In assessing and responding to risk, the practitioner should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the practitioner may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the practitioner may coordinate work with the internal auditors and reduce the number of locations or business units at which the practitioner would otherwise need to perform review procedures.

B13. The direction in paragraph 54 regarding special considerations for subsequent years' review means that the practitioner should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B14. *Special Situations*. The scope of the review should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. For equity method investments, the scope of the review should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The review ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the regulator allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the

practitioner may limit the audit in the same manner. In these situations, the practitioner report would not be affected by a scope limitation. However, the practitioner should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the practitioner review of internal control over financial reporting. Additionally, the practitioner should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the regulator's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the practitioner believes that management's disclosure about the limitation requires modification, the practitioner should follow the same communication responsibilities that are described in paragraphs 38 through 42 of ISRE 2410 - Review of Interim Financial Information Performed by the Independent Auditor of the Entity. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the practitioner should qualify his or her conclusion on the review of internal control over financial reporting to include an explanatory paragraph describing the reasons why the practitioner believes management's disclosure requires qualification.

Use of Service Organisations

B17. ISA 402, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of the company's information system. The practitioner may apply the relevant concepts described in ISA 402 to the review of internal control over financial reporting.

B18. Section 3 or ISA 402 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the practitioner should include the activities of the service organization when determining the evidence required to support his or her report.

B19. Section 9 through 17 of ISA 402 describe the procedures that the practitioner should perform with respect to the activities performed by the service organization. The procedures include –

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and
b. Obtaining evidence that the controls that are relevant to the practitioner's report are operating effectively.

B20. Evidence that the controls that are relevant to the practitioner's report are operating

effectively may be obtained by following procedures described below

a. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

> Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period. A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

b. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent re-performance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

c. Performing tests of controls at the service organization.

B21. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,
- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and
- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

> Note: These factors are similar to factors the practitioner would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in sections 9 to 14 of ISA 402.

B22. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the practitioner should evaluate whether the

company is applying the necessary procedures.

B23. In determining whether the service auditor's report provides sufficient evidence to support the practitioner's report, the practitioner should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph A32 to A41 of ISA 600 (Special considerations including the work of component/specialized auditors)

B24. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The practitioner should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the practitioner should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The practitioner also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B25. The practitioner should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include –

- Evaluating procedures performed by management and the results of those procedures.

- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B27. The practitioner should not refer to the service auditor's report when providing his review report on internal control over financial reporting.

Benchmarking of Automated Controls

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the practitioner may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the practitioner should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B31. To determine whether to use a benchmarking strategy, the practitioner should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are –

- The extent to which the application control can be matched to a defined program within an application.
- The extent to which the application is stable (i.e., there are few changes from period to period).

B32. The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed. remote – e.g., when the vendor does not allow access or modification to the source code.

B33. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors –

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.
- The practitioner's understanding of the nature of changes, if any, on the specific programs that contain the controls.
- The nature and timing of other related tests.
- The consequences of errors associated with the application control that was benchmarked.
- Whether the control is sensitive to other business factors that may have

changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

ISA 315 paragraph 18. The information system, including the related business processes, relevant to financial reporting, and communication

- The practitioner shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:
    - The classes of transactions in the entity's operations that are significant to the financial statements;
    - The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
    - The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
    - How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
    - The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
    - Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref ISA 240 : Para. A89-A93)
    -
- The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

    - Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
    - Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
    - Process and account for system overrides or bypasses to controls;
    - 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.

- 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.
  - An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard 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.
- 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 include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities: Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small 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 may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

APPENDIX C – Special Reporting Situations

Report Qualifications

C1. The practitioner should qualify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented,
b. There is a restriction on the scope of the engagement,
c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report,
d. There is other information contained in management's annual report on internal control over financial reporting, or
e. Management's annual certification pursuant to Section 60 to 61 of the Investment and Securities Act (ISA) is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented*. If the practitioner determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the practitioner should qualify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the practitioner should follow the direction in paragraph 85.

C3. *Scope Limitations*. The practitioner can express a conclusion on the company's internal control over financial reporting only if the practitioner has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the practitioner should withdraw from the engagement or issue a disclaimer of conclusion. A disclaimer of conclusion states that the practitioner does not express a conclusion on the effectiveness of internal control over financial reporting.

C4. When disclaiming a conclusion because of a scope limitation, the practitioner should state that the scope of the assurance engagement was not sufficient to warrant the expression of a conclusion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The practitioner should not identify the procedures that were performed nor include the statements describing the characteristics of an assurance engagement to report internal control over financial reporting (paragraph 83 g, h, and i); to do so might overshadow the disclaimer.

C5. When the practitioner plans to disclaim a conclusion and the procedures performed by the practitioner caused the practitioner to conclude that a material weakness exists, the practitioner's report also should include:

- The definition of a material weakness, as provided in paragraph A7.
- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the assurance report with specific information about the nature of any

material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 87.

C6. The practitioner may issue a report disclaiming a conclusion on internal control over financial reporting as soon as the practitioner concludes that a scope limitation will prevent the practitioner from obtaining the assurance necessary to express a conclusion. The practitioner is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express a conclusion.

Note: In this case, in following the direction in paragraph 89 regarding dating the practitioner's report, the report date is the date that the practitioner has obtained sufficient competent evidence to support the representations in the practitioner's report.

C7. If the practitioner concludes that he or she cannot express a conclusion because there has been a limitation on the scope of the assurance engagement, the practitioner should communicate, in writing, to management and the audit committee that the assurance on internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. The evaluation of the use of work of component auditors are the same in the assurance engagement to report on internal control over financial reporting as in the audit of the company's financial statements; accordingly, guidance on the use of components auditors and extent of reporting by the component auditors are the same for both types of engagements. ISA 600 –Audits of Group financial statements (including the work of component auditors), provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in ISA 600.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee

C11. When the practitioner decides to make reference to the report of the other auditor as a basis, in part, for his or her conclusion on the company's internal control over financial reporting, the practitioner should refer to the report of the other auditor when describing the scope of the assurance engagement and when expressing the conclusion.

C12. Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information. Management's annual report on internal control over financial reporting included in the company's financial statements, may contain information in addition to the elements described in paragraph 70 that are subject to the practitioner's evaluation.

C13. If management's annual report on internal control over financial reporting, included in the company's financial statements could reasonably be viewed by users of the report as including such additional information, the auditor, also the practitioner, should disclaim a conclusion on the information.

C14. If the auditor, also the practitioner believes that management's additional information included in the company's financial statements contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. ISA 240 and ISA 250 and other regulations e.g. BOFIA ACT paragraph 29 may also require the auditor to take additional action.

Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within as supplementary information in its annual report and financial statements, the auditor would not need to disclaim an opinion. However,

in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 60 -61 of Investment and Security Act is Misstated*. If matters come to the practitioner's attention as a result of the assurance engagement on internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring quarterly) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 60 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies, the practitioner should follow the communication responsibilities as described in ISRE 2410 *Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in ISRE 2410, the practitioner should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the practitioner believes management's disclosures should be modified.

Subsequent Events

C16. When the report on internal control over financial reporting is included in other documents such as offering documents, subsequent to the date of issuance of the report, the practitioner may have additional responsibilities relating to subsequent events that the practitioner may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the practitioner may be required to perform additional procedures to the date of the final offering document. These procedures may be similar to those referred to in paragraphs 6 and 7 of ISA 560, performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the report on internal control over financial reporting with which the practitioner is associated.

C17. When a practitioner's report is included in registration statements, proxy statements, or periodic reports filed under any regulatory requirements. The practitioner should apply guidance similar to ISA 560 with respect to the practitioner's report on internal control over financial reporting included in such filings. In addition, the practitioner should extend the direction in ISA 580 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on internal control over financial reporting.

C18. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit

report on financial statements and the audit report on internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

APPENDIX D – Using the work of internal auditors

The considerations are the same as for an auditor engaged to audit a set of financial statements. Accordingly, the practitioner should apply guidance in ISA 315 and 610(R).

- **This guidance** deals with the practitioner's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the practitioner.
- **This guidance** does not apply if the entity does not have an internal audit function. (Ref ISA 610: Para. A2)
- If the entity has an internal audit function, the requirements in this guidance relating to using the work of that function do not apply if:
    1. The responsibilities and activities of the function are not relevant to the Assurance Engagement; or
    2. Based on the practitioner's preliminary understanding of the function of internal audit function, the practitioner does not expect to use the work of the function in obtaining audit evidence.

  Nothing in **this guidance** requires the practitioner to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of procedures to be performed directly by the practitioner; it remains a decision of the practitioner in establishing the overall assurance engagement strategy.

- Furthermore, the requirements in **this guidance** relating to direct assistance do not apply if the practitioner does not plan to use internal auditors to provide direct assistance.

  In some jurisdictions, the practitioner may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function or using internal auditors to provide direct assistance. The guidance do not override laws or regulations that govern an assurance engagement on internal control over financial reporting. Such prohibitions or restrictions will therefore not prevent the practitioner from complying with the guidance. (Ref ISA 610: Para. A31).

- Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

- ISA 315 (Revised) addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment and identification and assessment of risks of material misstatement. ISA 315 (Revised) also explains how effective communication between the internal and external auditors also creates an environment in which

the external auditor can be informed of significant matters that may affect the external auditor's work.

- Depending on whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competency of the internal audit function, and whether the function applies a systematic and disciplined approach, the external auditor may also be able to use the work of the internal audit function in a constructive and complementary manner. This ISA addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function obtained as a result of procedures performed under ISA 315 (Revised), the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained. Such use of that work modifies the nature or timing, or reduces the extent, of audit procedures to be performed directly by the external auditor.
- In addition, this ISA also addresses the external auditor's responsibilities if considering using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.
- There may be individuals in an entity that perform procedures similar to those performed by an internal audit function. However, unless performed by an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered internal controls and obtaining evidence regarding the effectiveness of such controls would be part of the auditor's responses to assessed risks in accordance with ISA 330.

The Practitioner's Responsibility for the Assurance Engagement

- The practitioner has sole responsibility for his report on the Assurance engagement, and that responsibility is not reduced by the practitioner's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform procedures similar to those performed by the practitioner, neither the internal audit function nor the internal auditors are independent of the entity as is required of the practitioner. **This guidance**, therefore, defines the conditions that are necessary for the practitioner to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the assurance engagement. The requirements are designed to provide a framework for the practitioner's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

Objectives

- The objectives of the practitioner, where the entity has an internal audit function and the practitioner expects to use the work of the function to modify the nature

or timing, or reduce the extent, of procedures to be performed directly by the practitioner or to use internal auditors to provide direct assistance, are:

1. To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent;

   and having made that determination:
2. If using the work of the internal audit function, to determine whether that work is adequate for purposes of the assurance engagement; and
3. If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

Definition

- For purposes of the guidance, the following terms have the meaning attributed below:
  1. Internal audit function – A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes. (Ref ISA 610: Para. A1–A4)
  2. Direct assistance – The use of internal auditors to perform review procedures under the direction, supervision and review of the practitioner.

Requirements

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

- The practitioner shall determine whether the work of the internal audit function can be used for purposes of the assurance engagement by evaluating the following:
  1. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (Ref ISA 610: Para. A5–A9)
  2. The level of competence of the internal audit function; and (Ref ISA 610:Para. A5–A9)
  3. Whether the internal audit function applies a systematic and disciplined approach, including quality control. (Ref ISA 610: Para. A10–A11).
- The practitioner shall not use the work of the internal audit function if the practitioner determines that:
  1. The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
  2. The function lacks sufficient competence; or
  3. The function does not apply a systematic and disciplined approach, including quality control. (Ref 610: Para. A12–A14)

Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

- As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the practitioner shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the practitioner's overall review strategy and review plan. (Ref 610: Para. A15–A17).
- The practitioner shall make all significant judgments in the assurance engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly: (Ref ISA 610: Para. A15–A17).

1. The more judgment is involved in:
   - Planning and performing relevant review procedures; and
   - Evaluating the evidence gathered; (Ref 610: Para. A18–A19)
2. The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant; (Ref ISA 610: Para. A20–A22)
3. The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
4. The lower the level of competence of the internal audit function.

- The practitioner shall also evaluate whether, in aggregate, using the work of the internal audit function (Ref ISA 610: Para. A15–A22) to the extent planned would still result in the practitioner being sufficiently involved in the assurance engagement, given the practitioner's sole responsibility for the report issued on the assurance engagement.

- The practitioner shall, in communicating with those charged with governance an overview of the planned scope and timing of the engagement in accordance with ISA 260, communicate how the external auditor has planned to use the work of the internal audit function (Ref ISA 610: Para. A23).

Using the Work of the Internal Audit Function

- If the practitioner plans to use the work of the internal audit function, the practitioner shall discuss the planned use of its work with the function as a basis for coordinating their respective activities. (Ref 610: Para.A24–A26)
- The practitioner shall read the reports of the internal audit function relating to the work of the function that the practitioner plans to use to obtain an understanding of the nature and extent of review procedures it performed and the related findings.

- The practitioner shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the practitioner plans to use to determine its adequacy for purposes of the review engagement, including evaluating whether:
  1. The work of the function had been properly planned, performed, supervised, reviewed and documented;
  2. Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and
  3. Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed. (Ref ISA610: Para. A27–A30)
- The nature and extent of the practitioner's audit procedures shall be responsive to the practitioner's evaluation of:
  1. The amount of judgment involved;
  2. The assessed risk of material misstatement;
  3. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and
  4. The level of competence of the function; (Ref ISA 610: Para. A27–A29)

and shall include reperformance of some of the work. (Ref ISA 610: Para. A30)

- The practitioner shall also evaluate whether the practitioner's conclusions regarding the internal audit function in paragraph 13 of **this guidance** and the determination of the nature and extent of use of the work of the function for purposes of the review in paragraphs 18–19 of **this guidance** remain appropriate.

Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit

- The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. If so, paragraphs 27–35 and 37 do not apply. (Ref ISA 610: Para. 31)
- If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity. (Ref ISA 610: Para. A32–A34)

- The external auditor shall not use an internal auditor to provide direct assistance if:
  1. There are significant threats to the objectivity of the internal auditor; or
  2. The internal auditor lacks sufficient competence to perform the proposed work. (Ref ISA 610: Para. A32–A34)

  Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance

- In determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:
  1. The amount of judgment involved in:
     - Planning and performing relevant audit procedures; and
     - Evaluating the audit evidence gathered;
  2. The assessed risk of material misstatement; and
  3. The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance. (Ref: ISA 610 Para. A35–A39)
- The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:
  1. Involve making significant judgments in the audit; (Ref ISA 610: Para. A19)
  2. Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than ; (Ref: Para. A38)
  3. Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
  4. Relate to decisions the external auditor makes in accordance with this ISA regarding the internal audit function and the use of its work or direct assistance. (Ref: Para. A35–A39)
- Having appropriately evaluated whether and, if so, to what extent internal auditors can be used to provide direct assistance on the audit, the external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with ISA 260, communicate the nature and extent of the planned use of internal auditors to provide direct assistance so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement. (Ref ISA 610: Para. A39)
- The external auditor shall evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

Using Internal Auditors to Provide Direct Assistance

- Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:
  1. Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
  2. Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.
- The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220. In so doing:
  1. The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the factors in paragraph 29 of this ISA; and
  2. The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

  The direction, supervision and review by the external auditor of the work performed by the internal auditors shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work. (Ref: ISA 610Para. A40–A41)

- In directing, supervising and reviewing the work performed by internal auditors, the external auditor shall remain alert for indications that the external auditor's evaluations in paragraph 27 are no longer appropriate.

  Documentation

- If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:

  The evaluation of:

  - Whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors;
  - The level of competence of the function; and
  - Whether the function applies a systematic and disciplined approach, including quality control;

  2. The nature and extent of the work used and the basis for that decision; and
  3. The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

37. If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor shall include in the audit documentation:

a. The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;

b. The basis for the decision regarding the nature and extent of the work performed by the internal auditors;

c. Who reviewed the work performed and the date and extent of that review in accordance with ISA 230;

d. The written agreements obtained from an authorized representative of the entity and the internal auditors under paragraph 33 of **this guidance**; and

e. The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

Application and Other Explanatory Material

Definition of Internal Audit Function (Ref ISA 610: Para. 2, 14a)

A1. The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

Activities Relating to Governance

- The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

Activities Relating to Risk Management

- The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures to assist the entity in the detection of fraud.

Activities Relating to Internal Control

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.
- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

ISA 610 A2. Activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function, nor whether it is performed by the entity or a third-party service provider, are sole determinants of whether or not the external auditor can use the work of the function. Rather, it is the nature of the activities; the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; competence; and systematic and disciplined approach of the function that are relevant. References in **this guidance** to the work of the internal audit function include relevant activities of other functions or third-party providers that have these characteristics.

ISA 610 A3. In addition, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this ISA, although they may perform control activities that can be tested in accordance with ISA 330. For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.

ISA 610 A4. While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:

- To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud. In this regard, ISA 315 (Revised) requires the external auditor to obtain an understanding of the nature of the internal audit function's responsibilities, its status within the organization, and the activities performed, or to be performed, and make inquiries of appropriate individuals within the internal audit function (if the entity has such a function); or
- Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor.

In addition, unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (referred to as "direct assistance" in this ISA).

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

Objectivity and Competence (Ref ISA 610: Para. 15a and b)

ISA 610 A5. The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function can be used in the circumstances.

ISA 610 A6. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.

ISA 610 A7. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments. Factors that may affect the external auditor's evaluation include the following:

- Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments. For example, whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.

- Whether the internal audit function is free of any conflicting responsibilities, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.
- Whether those charged with governance oversee employment decisions related to the internal audit function, for example, determining the appropriate remuneration policy.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance, for example, in communicating the internal audit function's findings to the external auditor.
- Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity, or whether their internal policies achieve the same objectives.

ISA 610 A8. Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards. Factors that may affect the external auditor's determination include the following:

- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
- Whether the internal auditors have adequate technical training and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.
- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards including continuing professional development requirements.

ISA 610 A9. Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

Application of a Systematic and Disciplined Approach (Ref: Para. 15c)

ISA 610 A10. The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

ISA 610 A11. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the internal audit function has appropriate quality control policies and procedures, for example, such as those policies and procedures in ISQC 1 that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

Circumstances When Work of the Internal Audit Function Cannot Be Used (Ref: Para. 14)

ISA 610 A12. The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence.

ISA 610 A13. Consideration of the factors in referenced paragraphs A7, A8 and A11 of ISA 610 included **this guidance** individually and in aggregate is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management, this would be considered a significant threat to the function's objectivity unless other factors such as those described in paragraph ref A7 of this section collectively provide sufficient safeguards to reduce the threat to an acceptable level.

ISA 610 A14. In addition, the IESBA Code states that a self-review threat is created when the external auditor accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the audit. This is because of the possibility that the engagement team will use the results of the internal

audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. The IESBA Code discusses the prohibitions that apply in certain circumstances and the safeguards that can be applied to reduce the threats to an acceptable level in other circumstances.

Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

Factors Affecting the Determination of the Nature and Extent of the Work of the Internal Audit Function that Can Be Used (Ref: Para. 17–19)

ISA 610 A15. Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established in accordance with ISA 300.

ISA 610 A16. Examples of work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of ISA 600).

ISA 610 A17. The external auditor's determination of the planned nature and extent of use of the work of the internal audit function will be influenced by the external auditor's evaluation of the extent to which the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the level of competence of the internal audit function in paragraph 18 of **this guidance**. In addition, the amount of judgment needed in planning, performing and evaluating such work and the assessed risk of material misstatement at the assertion level are inputs to the external auditor's determination. Further, there are circumstances in which the external auditor cannot use the work of the internal audit function for purpose of the audit as described in paragraph 16 of **this guidance**.

Judgments in planning and performing audit procedures and evaluating results (Ref: Para. 18a and 30a)

ISA 610A18. The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor

will need to perform more procedures directly in accordance with paragraph 18 of this ISA, because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

ISA 610 A19. Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement in accordance with paragraph 18. Significant judgments include the following:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

Assessed risk of material misstatement (Ref: Para. 18b)

ISA 610 A20. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly in accordance with paragraph 16 of this ISA, and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in ISA 200, the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

ISA 610 A21. As explained in ISA 315 (Revised), significant risks require special audit consideration and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, where the risks of material misstatement is other than low, the use of the work of the internal audit function alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

ISA 610 A22. Carrying out procedures in accordance with this ISA may cause the external auditor to reevaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether to use the work of the internal audit function and whether further application of this ISA is necessary.

Communication with Those Charged with Governance (Ref ISA 610 : Para. 20)

ISA 610 A23. In accordance with ISA 260, the external auditor is required to communicate with those charged with governance an overview of the planned scope and timing of the audit. The planned use of the work of the

internal audit function is an integral part of the external auditor's overall audit strategy and is therefore relevant to those charged with governance for their understanding of the proposed audit approach.

Using the Work of the Internal Audit Function

Discussion and Coordination with the Internal Audit Function (Ref: Para. 21)

ISA 610 A24. In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work.
- The nature of the work performed.
- The extent of audit coverage.
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
- Proposed methods of item selection and sample sizes.
- Documentation of the work performed.
- Review and reporting procedures.

ISA 610 A25. Coordination between the external auditor and the internal audit function is effective when, for example:

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

ISA 610 A26. ISA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor 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. In addition, if such information may be indicative of a heightened risk of a material misstatement of the

financial statements or may be regarding any actual, suspected or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with ISA 240.

Procedures to Determine the Adequacy of Work of the Internal Audit Function (Ref ISA 610:Para. 23–24)

ISA 610 A27. The external auditor's audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use provide a basis for evaluating the overall quality of the function's work and the objectivity with which it has been performed.

ISA 610 A28. The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph 24, include the following:

- Making inquiries of appropriate individuals within the internal audit function.
- Observing procedures performed by the internal audit function.
- Reviewing the internal audit function's work program and working papers.

ISA 610 A29. The more judgment involved, the higher the assessed risk of material misstatement, the less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or the lower the level of competence of the internal audit function, the more audit procedures are needed to be performed by the external auditor on the overall body of work of the function to support the decision to use the work of the function in obtaining sufficient appropriate audit evidence on which to base the audit opinion.

Reperformance (Ref: Para. 24)

ISA 610 A30. For purposes of this ISA, reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may e accomplished by examining items already examined by the internal audit function, or where it is not possible to do so, the same objective may also be accomplished by examining sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures the external auditor may perform in paragraph A28. While it is not necessary for the external auditor to do reperformance in each area of work of the internal audit function that is being used, some reperformance is required on the body of work of the internal audit function as a whole that the external auditor plans to use in accordance with paragraph 24. The external auditor is more likely to focus reperformance in those areas where more judgment was exercised by the internal audit function in planning, performing and evaluating the results of the audit procedures and in areas of higher risk of material misstatement.

Determining Whether, in Which Areas and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit (Ref: Para. 5, 26–28)

ISA 610 A31. In jurisdictions where the practitioner is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the group auditors to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.

ISA 610 A32. As stated in referenced ISA 610 paragraph A7 included in this guidance, objectivity refers to the ability to perform the proposed work without allowing bias, conflict of interest or undue influence of others to override professional judgments. In evaluating the existence and significance of threats to the objectivity of an internal auditor, the following factors may be relevant:

- The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
- Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.
- Association with the division or department in the entity to which the work relates.
- Significant financial interests in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority.

Material issued by relevant professional bodies for internal auditors may provide additional useful guidance.

ISA 610 A33. There may also be some circumstances in which the significance of the threats to the objectivity of an internal auditor is such that there are no safeguards that could reduce them to an acceptable level. For example, because the adequacy of safeguards is influenced by the significance of the work in the context of the audit, paragraph 30 (a) and (b) prohibits the use of internal auditors to provide direct assistance in relation to performing procedures that involve making significant judgments in the audit or that relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited. This would also be the case where the work involved creates a self-review threat, which is why internal auditors are prohibited from performing procedures in the circumstances described in paragraph 30 (c) and (d).

ISA 610 A34. In evaluating the level of competence of an internal auditor, many of the factors in paragraph A8 of this ISA may also be relevant, applied in the context of individual internal auditors and the work to which they may be assigned.

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance (Ref: Para. 29–31)

ISA 610 A35. Paragraphs A15–A22 provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors.

ISA 610 A36. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Examples of activities and tasks that would not be appropriate to use internal auditors to provide direct assistance include the following:

- Discussion of fraud risks. However, the external auditors may make inquiries of internal auditors about fraud risks in the organization in accordance with ISA 315 (Revised).
- Determination of unannounced audit procedures as addressed in ISA 240.

ISA 610 A37. Similarly, since in accordance with ISA 505 the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

ISA 610 A38. The amount of judgment involved and the risk of material misstatement are also relevant in determining the work that may be assigned to internal auditors providing direct assistance. For example, in circumstances where the valuation of accounts receivable is assessed as an area of higher risk, the external auditor could assign the checking of the accuracy of the aging to an internal auditor providing direct assistance. However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to an internal auditor providing direct assistance.

ISA 610 A39. Notwithstanding the direction, supervision and review by the external auditor, excessive use of internal auditors to provide direct assistance may affect perceptions regarding the independence of the external audit engagement.

Using Internal Auditors to Provide Direct Assistance

ISA 610 A40. As individuals in the internal audit function are not independent of the entity as is required of the external auditor when expressing an opinion on financial statements, the external auditor's direction, supervision and review of the work performed by internal auditors providing direct assistance will generally be of a different nature and more extensive than if members of the engagement team perform the work.

ISA 610 A41. In directing the internal auditors, the external auditor may, for example, remind the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditor. In reviewing the work performed by the internal auditors, the external auditor's considerations include whether the evidence obtained is sufficient and appropriate in the circumstances, and that it supports the conclusions reached.

APPENDIX E
Fraud Risk Assessment

The requirements for Fraud Risk Assessment in the assurance engagement to report on internal control over financial reporting is similar to that required in the audit of the financial statements; accordingly, practitioners are encouraged to make these assessment as they would do for an engagement to audit the financial statements of the company for which guidance is provided in ISA 240- *The auditor's responsibility to consider fraud in an audit of financial statements*.

A. Risk Assessment Procedures and Related Activities.

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, the practitioner shall perform the procedures below to obtain information for use in identifying the risks of material misstatement due to fraud.

I. Management and Others within the Entity

a) The auditor shall make inquiries of management regarding:

- Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref ISA 240: Appendix. A12 to A13)
- Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref ISA 240: Appendix. A14)
- Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
- Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

b) The practitioner shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref ISA: Appendix. A15)

c) For those entities that have an internal audit function, the practitioner shall make inquiries of appropriate individuals within the function to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref ISA 240: Appendix A16)

II. Those Charged with Governance

a) Unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref ISA 240: Appendix A17)

b) Unless all of those charged with governance are involved in managing the entity, the practitioner shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

III. Unusual or Unexpected Relationships Identified

a) The practitioner shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

IV. Other Information

a) The practitioner shall consider whether other information obtained by the practitioner indicates risks of material misstatement due to fraud. (Ref: ISA 240 Appendix. A18)

V. Evaluation of Fraud Risk Factors

a) The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref ISA 240: Appendix. A19)

B. Identification and Assessment of the Risks of Material Misstatement Due to Fraud

1. The practitioner shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.

2. When identifying and assessing the risks of material misstatement due to fraud, the practitioner shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Where the practitioner concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud, the practitioner shall include in its documentation the reasons for that conclusion (Ref ISA 240: Appendix. A21)

3. The practitioner shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the practitioner shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref ISA 240: Appendix. A22)

ISA 240 A13. Inquiries of Management

- Management's Assessment of the Risk of Material Misstatement Due to Fraud Management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the practitioner to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.
- Considerations specific to smaller entities

In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

ISA 240 A14. Management's Process for Identifying and Responding to the Risks of Fraud

In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

ISA 240 A15. Inquiry of Management and Others within the Entity

- The practitioner's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the practitioner that may not otherwise be communicated.

- Examples of others within the entity to whom the practitioner may direct inquiries about the existence or suspicion of fraud include:

  1. Operating personnel not directly involved in the financial reporting process.
  2. Employees with different levels of authority.
  3. Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
  4. In-house legal counsel.
  5. Chief ethics officer or equivalent person.
  6. The person or persons charged with dealing with allegations of fraud.

- Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the practitioner may judge it necessary to corroborate responses to inquiries with other information.

ISA 240 A16. Inquiries of the Internal Audit Function (

Appendix D establishes requirements and provide guidance relevant to audits of those entities that have an internal audit function. In carrying out the requirements of those ISAs in the context of fraud, the practitioner may inquire about specific activities of the function including, for example:

- The procedures performed, if any, by the internal audit function during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

ISA 240 A.17 Obtaining an Understanding of Oversight Exercised by Those Charged with Governance

- Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity and by country, it is important that the practitioner understands their respective

responsibilities to enable the practitioner to obtain an understanding of the oversight exercised by the appropriate individuals.

- An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The practitioner may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.
- Considerations Specific to Smaller Entities: In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the practitioner because there is no oversight separate from management.

ISA 240 A.18 Consideration of Other Information

- In addition to information obtained from applying relevant procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the practitioner's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

ISA 240 A19. Evaluation of Fraud Risk Factors

a) The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the practitioner may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

    - The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
    - The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
    - A control environment that is not effective may create an opportunity to commit fraud.

b) Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material

misstatement of the financial statements due to fraud requires the exercise of professional judgment.

c) Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix E20 below. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

d) Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the practitioner may become aware of the existence of such information. Although the fraud risk factors described in Appendix E20 cover a broad range of situations that may be faced by practioners, they are only examples and other risk factors may exist.

e) The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

f) Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

g) Considerations Specific to Smaller Entities: In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control since there is an opportunity for management override of controls.

ISA 240 A20. Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by practitioners in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the practitioner's consideration – that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations

created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive – including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow. Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.
- Personal guarantees of debts of the entity.

There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of staff in accounting, information technology, or the internal audit function that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.

- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
    - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
    - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
    - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
    - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other re-imbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

ISA 240 A21 Identification and Assessment of the Risks of Material Misstatement Due to Fraud

Risks of Fraud in Revenue Recognition

- Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.
- The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year over year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.
- The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the practitioner may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where a there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

ISA 240 A31. Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related 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. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.
- It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.