



Subject: Agenda for the 102nd meeting of the AUASB
Venue: Teleconference (Refer dial in details in calendar invitation)
Date & Time: Tuesday 31 July 2pm – 4pm
Apologies: None

Time	Agenda Item	Responsibility
2:00pm	1. Welcome & Introduction	Roger
2:10pm	2. Explanatory Guide – ED ASA 315 & ED ASA 540	Rene
2:25pm	3. ED ASA 315	Anne
3:10pm	4. ED ASA 540	Rene
3:55pm	5. Any Other Business	Roger
4.00pm	Close	

This AUASB meeting is open to members of the public. Observers wanting to attend the teleconference should register via email at enquiries@auasb.gov.au.

AGENDA PAPERS

Auditing and Assurance Standards Board – 102nd Meeting

Agenda Number(s)		Mail Out 1 25/07/2018	Mail Out 2 27/07/2018
1	AUASB Meeting Agenda (this document)	✓	
2	Board Meeting Summary Paper - Explanatory Guide ED 01/18, ED 02/18, ED 03/18 & ED 04/18	✓	
2(a)	Explanatory Guide ED 01/18, ED 02/18, ED 03/18 & ED 04/18	✓	
3	Board Meeting Summary Paper – ED ASA 315 <i>Identifying and Assessing the Risks of Material Misstatement</i>	✓	
3(a)	Explanatory Memorandum - Exposure draft 01/18: <i>Identifying and Assessing the Risks of Material Misstatement</i> and Exposure draft 02/18: <i>Amendments to Australian Auditing Standards</i>	✓	
3(b)	ED 01/18: <i>Identifying and Assessing the Risks of Material Misstatement</i>	✓	
3(c)	ED 02/18 - <i>Amendments to Australian Auditing Standards</i>	✓	
3(d)	Proposed Timetable for ED 01/18 and 02/18	✓	
4	AUASB Board Meeting Summary Paper – ED ASA 540		✓
4(a)	AUASB Board Meeting Summary Paper Attachment – ED ASA 540		✓
4(b)	Exposure Draft 03/18 ASA 540 <i>Auditing Accounting Estimates and Related Disclosures</i>		✓
4(c)	Exposure Draft 04/18 <i>Amendments to Australian Auditing Standards</i>		✓
4(d)	Explanatory Memorandum Exposure Draft 03/18: <i>Auditing Accounting Estimates and Related Disclosures</i> ; and Exposure Draft 04/18: <i>Amendments to Australian Auditing Standards</i>		✓
4(e)	Principles of Convergence to International Standards of the International Auditing and Assurance Standards Board (IAASB) and Harmonisation with the Standards of the New Zealand Auditing and Assurance Standards Board (NZAuASB)		✓



AUASB Board Meeting Summary Paper

AGENDA ITEM NO. **2**

Meeting Date: 31 July 2018

Subject: Explanatory Guide to ED ASA 315 *Identifying and Assessing the Risks of Material Misstatement* and ED ASA 540 *Auditing Accounting Estimates and Related Disclosures*

Date Prepared: 23 July 2018

Prepared by: Rene Herman

☒ Action Required

☐ For Information Purposes Only

Agenda Item Objectives

1. The purpose of the Explanatory Guide is to summarise for Australian stakeholders:
 - (a) the series of exposure drafts that will be released by the AUASB in August 2018;
 - (b) the purpose of each exposure draft; and
 - (c) details of the change in the AUASB process undertaken for the exposure of ED ASA 315 *Identifying and Assessing the Risks of Material Misstatement*.
2. **The AUASB is requested to review and approve the Explanatory Guide.**

Matters to Consider

Refer Agenda Item 2(a) Explanatory Guide

Material Presented

Agenda Item 2	AUASB Board Meeting Summary Paper
Agenda Item 2(a)	Explanatory Guide

This document contains preliminary views and/or AUASB Technical Group recommendations to be considered at a meeting of the AUASB, and does not necessarily reflect the final decisions of the AUASB. No responsibility is taken for the results of actions or omissions to act on the basis of reliance on any information contained in this document (including any attachments), or for any errors or omissions in it.

Explanatory Guide

ED 01/18: Identifying and Assessing the Risks of Material Misstatement

ED 02/18: Amendments to Australian Auditing Standards

ED 03/18: Auditing Accounting Estimates and Related Disclosures

ED 04/18: Amendments to Australian Auditing Standards

Issued by the Auditing and Assurance Standards Board



Australian Government

Auditing and Assurance Standards Board

Obtaining a Copy of this Explanatory Guide

This Explanatory Memorandum is available on the Auditing and Assurance Standards Board (AUASB) website: www.auasb.gov.au

Contact Details

Auditing and Assurance Standards Board
Podium Level 14, 530 Collins Street
Melbourne Victoria 3000 AUSTRALIA

Phone: (03) 8080 7400
Fax: (03) 8080 7450
E-mail: enquiries@auasb.gov.au

Postal Address:

PO Box 204, Collins Street West
Melbourne Victoria 8007 AUSTRALIA

COPYRIGHT

© 2018 Auditing and Assurance Standards Board (AUASB). The text, graphics and layout of this document are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source as being the AUASB.

Requests and enquiries concerning reproduction and rights for commercial purposes should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Otherwise, no part of this document may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

ISSN 2201-3644

Introduction

1. The Auditing and Assurance Standards Board (AUASB) has/will release the following Explanatory Memorandums and related Exposure Drafts:

In relation to ED 315 Identifying and Assessing the Risks of Material Misstatement

- (a) Explanatory Memorandum Exposure Draft: *Identifying and Assessing the Risks of Material Misstatement*
- (b) Exposure Draft 01/18: *Identifying and Assessing the Risks of Material Misstatement* (ED 01/18)
- (c) Exposure Draft 02/18: *Amendments to Australian Auditing Standards*

In relation to ED 540 Auditing Accounting Estimates and Related Disclosures

- (a) Explanatory Memorandum Exposure Draft: *Auditing Accounting Estimates and Related Disclosures*
 - (b) Exposure Draft 03/18: *Auditing Accounting Estimates and Related Disclosures* (ED 02/18)
 - (c) Exposure Draft 04/18: *Amendments to Australian Auditing Standards*
2. The Exposure Drafts will be open to constituents for a 70 day comment period, closing 15 October 2018.
 3. Roundtable discussions on ED 01/18, ED 02/18, ED 03/18 and ED 04/18 will be held in September and October in Melbourne, Sydney, Perth, Adelaide, Brisbane and Canberra. Additionally, the AUASB will hold a webinar on these topics and stakeholders can provide feedback in writing directly to the office of the AUASB at enquiries@auasb.gov.au

Purpose

4. ED 01/18 is the Australian Exposure Draft of the equivalent IAASB exposure draft. Feedback on ED 01/18 will be used to inform the AUASB's submission to the IAASB on the IAASB's Proposed International Standard on Auditing 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement*.
5. ED 02/18 is the Australian Exposure Draft to make amendments to the Australian Auditing Standards. The amendments to the Australian Auditing Standards comprise related consequential changes arising from the proposed revision of ED ASA 315.
6. ED 03/18 is the Australian Exposure Draft of the final revised IAASB's ISA 540 *Auditing Accounting Estimates and Related Disclosures*. Feedback on ED 03/18 will be used to inform the AUASB as to any requirements and guidance that may be needed in addition to, or a clarification of, the equivalent ISA only when there are compelling reasons to do so. At the completion of the exposure period, the AUASB will consider constituents' submissions and where the AUASB determines that compelling reason exist, amendments to the exposure draft will be made.
7. ED 04/18 is the Australian Exposure Draft to make amendments to the Australian Auditing Standards. The amendments to the Australian Auditing Standards comprise related consequential changes arising from the proposed revision of ED ASA 540.

Change in AUASB process:

8. The AUASB has historically exposed Australian versions of the finalised IAASB standard. This is the process that will be undertaken in connection with the issuance of ED 03/18 and ED 04/18.
9. In order to optimise process effectiveness and efficiency, the AUASB agreed to trial issuing an exposure draft in Australia concurrently with the IAASB's exposure draft. This is the process undertaken in the issuance of ED 01/18 and ED 02/18.

10. At the completion of this process, the AUASB will evaluate both processes and will determine the most effective and efficient way forward. The AUASB welcomes any feedback on the process to enquiries@auasb.gov.au.

Draft



AUASB Board Meeting Summary Paper

AGENDA ITEM NO. **3**

Meeting Date: 31 July 2018

Subject: ED ASA 315 *Identifying and Assessing the Risks of Material Misstatement*

Date Prepared: 23 July 2018

Prepared By: Anne Waters

☒ Action Required

☐ For Information Purposes Only

Agenda Item Objectives

- I. For the AUASB to approve:
 - (a) Exposure Draft 01/18 ASA 315 *Identifying and Assessing the Risks of Material Misstatement* (ED 01/18)
 - (b) Exposure Draft 02/18 ASA 315 *Conforming and Consequential Amendments* (ED 02/18)
 - (c) The timetable for release of ED 01/18 and 02/18, planned outreach and submission to the IAASB.

Background

1. The IAASB issued Exposure Draft ISA 315 (Revised), *Identifying and Assessing the risks of Material Misstatement, and conforming and consequential amendments* (ED-ISA 315) on 17 July 2018, with comments due by 2 November 2018.
2. The AUASB makes formal submissions on Exposure Drafts (ED) issued by the IAASB to contribute to the setting of international auditing and assurance standards.
3. The AUASB agreed at its meeting on 17 April 2018, to trial issuing EDs in Australia concurrently with the IAASB's ED-ISA 315.
4. At its meeting on 13 June 2018 the AUASB discussed the development of proposed ISA 315 (Revised) which was being voted on for issuance as an ED at the upcoming IAASB June 2018 meeting. AUASB members highlighted a number of issues such as the flow of the standard and the introduction of new terms which were communicated to Fiona Campbell, IAASB Member and Chair of the ISA 315 Task Force, and to Lyn Provost, IAASB member.

This document contains preliminary views and/or AUASB Technical Group recommendations to be considered at a meeting of the AUASB, and does not necessarily reflect the final decisions of the AUASB. No responsibility is taken for the results of actions or omissions to act on the basis of reliance on any information contained in this document (including any attachments), or for any errors or omissions in it.

5. As a result of all the feedback received the ISA 315 Task Force made further changes to ED-ISA 315 which was unanimously approved by the IAASB with a 110 exposure period.
6. Not all matters raised by AUASB were clearly addressed and these will be considered for inclusion in the AUASB's submission on ED-ISA 315 to the IAASB.

Matters to Consider

Part A – General

7. ED 01/18 is the Australian equivalent of the IAASB's ED-315.
8. ED 02/18 includes the conforming and consequential amendments to the other ISAs.
9. Explanatory Memorandum Exposure draft: *Identifying and Assessing the risks of Material Misstatement, and conforming and consequential amendments* will accompany ED 01/18 (refer July18_3(a)_ExplanatoryMemorandum_ED0118). This also refers to the IAASB's Explanatory Memorandum which provides detailed background and explanations of the proposed amendments.
10. Note that the AUASB Technical Group to date, have not identified any Australian compelling reasons, which is consistent with ASA 315 extant ie. there are no Aus paragraphs. This will be considered further before finalising the final ASA, and after feedback is received from Australian constituents.
11. In addition to the EDs, outreach will be conducted through:
 - (a) roundtable discussions (also covering ASA 540 *Auditing Accounting Estimates and Related Disclosures*) held in September and October in Melbourne, Sydney, Perth, Adelaide, Brisbane and Canberra, and
 - (b) a webinar.

Part B – NZAuASB

12. The NZAuASB will issue the IAASB's ED-315 as an ED in New Zealand with no compelling reason amendments.

Part C – “Compelling Reasons” Assessment

13. No compelling reasons have been identified to date. Note that this will be reassessed after consideration of submissions received from Australian stakeholders, and the roundtables.

AUASB Actions

14. Read and consider:
 - (a) Explanatory Memorandum Exposure Draft: *Identifying and Assessing the risks of Material Misstatement, and conforming and consequential amendments* (refer July18_3(a)-_ExplanatoryMemorandum_ED0118)
 - (b) ED 01/18 ASA 315 (refer July18_3(b)_ED_01-18_ProposedASA315)

- (c) ED 02/18 ASA 315 Conforming and Consequential Amendments (refer July18_3(c)_ED_02-18_ProposedAmendingStandard)
 - (d) ASA 315 timetable (refer July18_3(d)_ED_01-18_timetable)
15. Consider if any other questions should be included in the ED.

AUASB Technical Group Recommendations

16. The AUASB approve:
- (a) ED 01/18 and ED 02/18 for issue in Australia with a comment period of 70 days.
 - (b) ASA 315 timetable.

Material Presented

Agenda Item 3 July18_3_BMSP_ASA 315_ED0118
 July18_3(a)_ExplanatoryMemorandum_ED0118
 July18_3(b)_ED_01-18_ProposedASA315
 July18_3(c)_ED_02-18_ProposedAmendingStandard
 July18_3(d)_ED_01-18_timetable



Agenda Item 3(a)
AUASB Meeting 31 July 2018

DRAFT

August 2018

Explanatory Memorandum

Exposure draft 01/18: Identifying and Assessing the Risks of Material Misstatement

Exposure draft 02/18: Proposed Auditing Standard ASA 2018-1 Amendments to Australian Auditing Standards

Issued by the Auditing and Assurance Standards Board



Obtaining a Copy of this Explanatory Memorandum

This Explanatory Memorandum is available on the Auditing and Assurance Standards Board (AUASB) website: www.auasb.gov.au

Contact Details

Auditing and Assurance Standards Board
Podium Level 14, 530 Collins Street
Melbourne Victoria 3000 AUSTRALIA

Phone: (03) 8080 7400
Fax: (03) 8080 7450
E-mail: enquiries@auasb.gov.au

Postal Address:

PO Box 204, Collins Street West
Melbourne Victoria 8007 AUSTRALIA

COPYRIGHT

© 2018 Auditing and Assurance Standards Board (AUASB). The text, graphics and layout of this document are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source as being the AUASB.

Requests and enquiries concerning reproduction and rights for commercial purposes should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Otherwise, no part of this document may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

ISSN 2201-3644

Important Note and Disclaimer

This Explanatory Memorandum is issued by the AUASB to provide information to auditors and assurance practitioners about the AUASB's implementation in Australia of the IAASB's proposed ISA 315 *Identifying and Assessing the Risks of Material Misstatement* and Proposed Consequential and Conforming Amendments.

This Explanatory Memorandum does not establish or extend the requirements under an existing AUASB Standard(s) and is not intended to be a substitute for compliance with the relevant AUASB Standards with which auditors and assurance practitioners are required to comply when conducting an audit or other assurance engagement. No responsibility is taken for the results of actions or omissions to act on the basis of any information contained in this document or for any errors or omissions in it.

CONTENTS

	<i>Paragraph</i>
Purpose	1-2
Composition of ED-315	3-5
Exposure Draft Questions	6-7
Background	
IAASB	8-11
AUASB	12-16
The AUASB's approach	17-21
Other Outreach Activities	22
Application	23-24
Website Resources	25

EXPLANATORY MEMORANDUM

Exposure Draft: Identifying and Assessing the Risks of Material Misstatement

Purpose

1. The International Auditing and Assurance Standards Board (IAASB) have issued Exposure Draft ISA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement*, and conforming and consequential amendments.
2. The AUASB is seeking feedback from constituents on this ED to inform us when developing our response to the IAASB, and when considering whether there are any compelling reasons for the proposals to be modified for application in Australia.
3. The aim of this Explanatory Memorandum is to provide constituents with information about ED 01/18 ASA 315 *Identifying and Assessing the Risks of Material Misstatement* (ED 01/18), and ED 02/18 Proposed Auditing Standard ASA 2018-1 *Amendments to Australian Auditing Standards* (ED 02/18), and the Auditing and Assurance Standards Board's (AUASB) approach to implementing in Australia.

Composition of ED 01/18 and 02/18

4. ED 01/18 includes proposed amendments to ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.
5. ED 02/18 includes:
 - (a) the proposed conforming and consequential amendments to ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* and ASA 330 *The Auditor's Response to Assessed Risks*.
 - (b) the proposed conforming and consequential amendments to other ASAs are detailed in Appendix 1.
6. Consequential and conforming amendments to ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* will be released by the IAASB once ISA 315 is released as a final standard.

Exposure Draft Questions

7. Constituents are asked to respond to questions:
 - (a) which the IAASB have requested feedback on, which will inform the AUASB when developing our response to the IAASB; and
 - (b) to assist the AUASB in assessing the impact of Australian applicable laws and regulations, and whether any compelling reasons exist, which would result in modifications to the final standard for application in Australia.
8. Refer to ED 01/18 and ED 02/18 for the detailed questions.

Background

IAASB

9. A strategic objective of the IAASB is to ensure the ISAs continue to form the basis for high quality, valuable and relevant audits conducted worldwide by responding on a timely basis to issues noted in practice and emerging developments.
10. ED 01/18 and ED 02/18 are part of the IAASB's commitment to advancing audit quality globally.
11. ED 01/18 proposes essential enhancements to the auditor's risk assessment process, with the objective of establishing more robust requirements and appropriately detailed guidance to drive auditors to perform consistent and effective identification and assessment of the risks of material misstatement.
12. The more significant changes proposed in ED 01/18 are:
 - a comprehensive introduction section which provides an overview of the key concepts including an overview of the risk assessment process
 - new definitions including the definitions of inherent risk factors, relevant assertions and significant risk
 - a new "stand-back" requirement to re-assess and confirm the appropriateness of the auditor's assessment of classes of transactions, account balances and disclosures that are quantitatively or qualitatively material, and that have not been identified as significant
 - a new requirement to separately assess inherent risk and control risk
 - enhanced guidance in relation to scalability
 - increased emphasis on professional scepticism and the auditor's considerations relating to fraud
 - enhanced requirements and application material in relation to identifying and assessing IT applications, the risks arising from IT and general IT controls relevant to the audit
 - new application material in relation to how automated tools and techniques may be used in the risk assessment process
 - extended application material to provide guidance to the requirements

13. Further details can be found on the IAASB's website: <http://www.ifac.org/auditing-assurance>
- Explanatory Memorandum – includes details on the background and the process adopted by the IAASB in developing ED-315 and the significant changes proposed.
 - Flowcharts which accompany ED-315.

[Exposure Draft, ISA 315 \(Revised\), Identifying and Assessing the Risks of Material Misstatement | IFAC](#)

AUASB

14. The AUASB has a strategic objective to develop, issue and maintain high quality Australian Auditing Standards. The AUASB takes input received from Australian constituents into account when preparing its submissions to the IAASB. The AUASB makes formal submissions on EDs issued by the IAASB to contribute to the setting of international auditing and assurance standards.
15. In accordance with its mandates under section 227 of the *ASIC Act 2001* and the Financial Reporting Council's (FRC) Strategic Direction, the AUASB's policy is to adopt the IAASB's auditing standards (ISAs), unless there are compelling reasons not to do so; and to amend the ISAs only when there are compelling reasons to do so. The AUASB's principles of convergence with the ISAs and harmonisation with the New Zealand auditing standards can be found on the AUASB's website:
- http://www.auasb.gov.au/admin/file/content102/c3/Aug14_IAASB-NZAuASB_Principles_of_Convergence_and_Harmonisation.pdf
16. Compelling reasons fall broadly into two categories: legal and regulatory; and principles and practices considered appropriate in maintaining or improving audit quality in Australia. Compelling reasons are further guided by the AUASB's policy of harmonisation with the standards of the New Zealand Auditing and Assurance Standards Board (NZAuASB).
17. The AUASB will adopt the revised ISA 315 into the Australian Auditing Standards that are made under section 336 of the *Corporations Act 2001*. Prior to implementation, the AUASB is required to consult with constituents and accordingly now issues Exposure Draft ED 01/18 and 02/18 for public exposure and comment. All comments received from constituents are considered by the AUASB when providing comments to the IAASB and prior to finalisation of the proposed revised standard.

The AUASB's approach

Exposure Draft Protocols

18. The AUASB has developed ED 01/18 and ED 02/18 based on the IAASB's equivalent ED-315. The AUASB is seeking feedback from constituents to inform us when responding to the IAASB on ED-315, and to identify compelling reasons when it is appropriate to amend ISA 315.
19. Under its convergence policies, the AUASB continues to include requirements and guidance that are in addition to, or a clarification of, the equivalent ISA, only when the compelling reason test has been met. Any such modifications continue to be identified in the Australian Auditing Standards by paragraph numbering commencing with an "Aus" prefix. Any such changes do not diminish the requirements of the equivalent ISA. Note that no compelling reasons have been identified to date by the AUASB Technical Group, and included in ED 01/18 and ED 02/18.
20. In addition to those changes that meet the compelling reason test, the AUASB makes format and terminology changes to comply with requirements relating primarily to legislative

instruments. Such changes are machinery in nature and do not change the meaning of the equivalent ISA.

General

21. The exposure drafts (EDs) will be open to constituents for a **70 day comment period** closing on 15 October 2018. This is to allow constituents time to respond to the AUASB on the EDs, and for the AUASB to conduct further outreach and to collate all feedback into our submission to the IAASB due on 2 November 2018.
22. At the completion of the exposure period, the AUASB will consider constituents' submissions:
 - (a) to inform us when developing our response to the IAASB on their ED; and
 - (b) where the AUASB determines that a compelling reason exist, to inform us as to whether modifications may be required when we are adopting the final standard.

Other Outreach Activities

23. In addition to the public exposure process, during September and October 2018 the AUASB will conduct roundtable consultative meetings and a webinar, in conjunction with the AUASB exposure draft ED 03/18 Proposed ASA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*.

Application

24. It is proposed that the revised standard will be applicable for financial reporting periods **beginning on or after 15 December 2020**. This application date corresponds with that of the equivalent ISA.

Early Adoption

25. Consistent with the IAASB's policy, all Australian Auditing Standards may be early adopted unless explicitly prohibited.

Website Resources

26. The AUASB welcomes constituents' input to the development of Australian Auditing Standards and regards both supportive and critical comments as essential to a balanced review of the proposed standards. Constituents are encouraged to access the websites of the [AUASB](#) and the [IAASB](#) to obtain further information.

* *

EXPOSURE DRAFT

ED 01/18
(August 2018)

Proposed Auditing Standard ASA 315 *Identifying and Assessing the Risks of Material Misstatement*

Issued for Comment by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be received by no later than 15 October 2018. Comments should be addressed to:

The Chair
Auditing and Assurance Standards Board
PO Box 204, Collins Street West
Melbourne Victoria 8007 AUSTRALIA

Formal Submissions

Submissions should be lodged online via the “Work in Progress-Open for Comment” page of the Auditing and Assurance Standards Board (AUASB) website (www.auasb.gov.au/Work-In-Progress/Open-for-comment.aspx) as a PDF document and Word document.

A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AUASB website: www.auasb.gov.au

Contact Details

Auditing and Assurance Standards Board
Podium Level 14, 530 Collins Street
Melbourne Victoria 3000
AUSTRALIA

Phone: (03) 8080 7400
E-mail: enquiries@auasb.gov.au

Postal Address:
PO Box 204, Collins Street West
Melbourne Victoria 8007
AUSTRALIA

COPYRIGHT

© 2018 Auditing and Assurance Standards Board (AUASB). The text, graphics and layout of this Exposure Draft are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source as being the AUASB.

Requests and enquiries concerning reproduction and rights for commercial purposes within Australia should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Otherwise, no part of this Exposure Draft may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

This Exposure Draft reproduces substantial parts of the corresponding International Standard on Auditing issued by the International Auditing and Assurance Standards Board (IAASB) and published by the International Federation of Accountants (IFAC), in the manner described in the statement on Conformity with International Standards on Auditing. The AUASB acknowledges that IFAC is the owner of copyright in the International Standard on Auditing incorporated in this Exposure Draft throughout the world.

All existing rights in this material are reserved outside Australia. Reproduction outside Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use only.

Further information and requests for authorisations to reproduce this Exposure Draft for commercial purposes outside Australia should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Any decision to approve a request may also require the agreement of IFAC.

ISSN 1030-603X

CONTENTS

PREFACE

AUTHORITY STATEMENT

CONFORMITY WITH INTERNATIONAL STANDARDS ON AUDITING

	<i>Paragraphs</i>
Application	Aus 0.1-Aus 0.2
Operative Date	Aus 0.3
Introduction	
Scope of this Auditing Standard	1
Key Concepts in this ASA	2-13
Effective Date	14
Objective	15
Definitions	16
Requirements	
Risk Assessment Procedures and Related Activities	17-22
Obtaining an Understanding of the Entity and Its Environment and the Applicable Financial Reporting Framework	23-24
Obtaining an Understanding of the Entity's System of Internal Control	25-44
Identifying and Assessing the Risks of Material Misstatement	45-53
Documentation	54
Application and Other Explanatory Material	
Definitions	A1-A11
Risk Assessment Procedures and Related Activities	A12-A46
Obtaining an Understanding of the Entity and Its Environment and the Applicable Financial Reporting Framework	A47-A88
Obtaining an Understanding of the Entity's System of Internal Control	A89-A104
Understanding the Components of the Entity's System of Internal Control	A105-A200
Identifying and Assessing the Risks of Material Misstatement	A201-A243
Documentation	A244-A247
Appendix 1: Considerations for Understanding the Entity and its Business Model	
Appendix 2: Events and Conditions That May Indicate Susceptibility to Risks of Material Misstatement	
Appendix 3: Understanding the Entity's System of Internal Control	
Appendix 4: Considerations for Understanding General IT Controls	

PREFACE

Reasons for Issuing ED 01/18

The AUASB issues exposure draft ED 01/18 of proposed Auditing Standard ASA 315 *Identifying and Assessing the Risks of Material Misstatement* pursuant to the requirements of the legislative provisions and the Strategic Direction explained below.

The AUASB is a non corporate Commonwealth entity of the Australian Government established under section 227A of the *Australian Securities and Investments Commission Act 2001*, as amended (ASIC Act). Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislation Act 2003*.

Under the Strategic Direction given to the AUASB by the Financial Reporting Council (FRC), the AUASB is required, inter alia, to develop auditing standards that have a clear public interest focus and are of the highest quality. Under the Strategic Direction, the AUASB is required to have regard to any program initiated by the IAASB for the revision and enhancement of the International Standards on Auditing (ISAs) and to make appropriate consequential amendments to the Australian Auditing Standards.

Main Proposals

This proposed Auditing Standard represents the Australian equivalent of proposed ISA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement* issued for public comment (July 2018) and will replace the current ASA 315 issued by the AUASB in October 2009 and amended to December 2015.

This proposed Auditing Standard contains differences from the current ASA 315, as detailed in the Explanatory Memorandum Exposure draft 01/18: *Identifying and Assessing the Risks of Material Misstatement* and Exposure draft 02/18: *Proposed Auditing Standard ASA 2018-1 Amendments to Australian Auditing Standards* (Explanatory Memorandum).

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 15 December 2020.

Main changes from existing ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

For the main differences between this proposed Auditing Standard and the Auditing Standard that it supersedes, ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* issued in October 2009 and amended to December 2015, refer to the Explanatory Memorandum.

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of ASA 315 *Identifying and Assessing the Risks of Material Misstatement* by no later than 15 October 2018. The AUASB is seeking comments from respondents on the following questions:

Overall Questions

The IAASB asks for constituents views on:

1. Has ED 01/18 been appropriately restructured, clarified and modernized in order to promote a more consistent and robust process for the identification and assessment of the risks of material misstatement. In particular:
 - (a) Do the proposed changes help with the understandability of the risk identification and assessment process?
 - (b) Are the flowcharts helpful in understanding the flow of the standard (i.e., how the requirements interact and how they are iterative in nature)?
 - (c) Will the revisions promote a more robust process for the identification and assessment of the risks of material misstatement and do they appropriately address the public interest issues outlined in paragraphs 6–28?
 - (d) Are the new introductory paragraphs helpful?
2. Are the requirements and application material of ED 01/18 sufficiently scalable, including the ability to apply ED 01/18 to the audits of entities with a wide range of sizes, complexities and circumstances?
3. Do respondents agree with the approach taken to enhancing ED 01/18 in relation to automated tools and techniques, including data analytics, through the use of examples to illustrate how these are used in an audit (see Appendix 1 of the IAASB's Explanatory Memorandum for references to the relevant paragraphs in ED 01/18)? Are there other areas within ED 01/18 where further guidance is needed in relation to automated tools and techniques, and what is the nature of the necessary guidance?
4. Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk identification and assessment process? Do you support the proposed change for the auditor to obtain 'sufficient appropriate audit evidence'¹ through the performance of risk assessment procedures to provide the basis for the identification and assessment of the risks of material misstatement, and do you believe this clarification will further encourage professional scepticism?

Specific Questions

5. Do the proposals made relating to the auditor's understanding of the entity's system of internal control² assist with understanding the nature and extent of the work effort required and the relationship of the work effort to the identification and assessment of the risks or material misstatement? Specifically:
 - (a) Have the requirements related to the auditor's understanding of each component of the entity's system of internal control been appropriately enhanced and clarified? Is it clear why the understanding is obtained and how this informs the risk identification and assessment process?
 - (b) Have the requirements related to the auditor's identification of controls relevant to the audit³ been appropriately enhanced and clarified? Is it clear how controls relevant to the audit are identified, particularly for audits of smaller and less complex entities?

¹ See paragraph 27 of the IAASB's Explanatory Memorandum and paragraph 17 of ED 01/18

² Paragraphs 25-44 and A89-A200 of ED 01/18

³ See ED 01/18, paragraphs 39-40 and paragraphs 37-40 of the IAASB's Explanatory Memorandum

- (c) Do you support the introduction of the new IT-related concepts and definitions? Are the enhanced requirements and application material related to the auditor's understanding of the IT environment, the identification of the risks arising from IT and the identification of general IT controls sufficient to support the auditor's consideration of the effects of the entity's use of IT on the identification and assessment of the risks of material misstatement?
6. Will the proposed enhanced framework for the identification and assessment of the risks of material misstatement result in a more robust risk assessment? Specifically:
- (a) Do you support separate assessments of inherent and control risk at the assertion level, and are the revised requirements and guidance appropriate to support the separate assessments?⁴
 - (b) Do you support the introduction of the concepts and definitions of 'inherent risk factors'⁵ to help identify risks of material misstatement and assess inherent risk? Is there sufficient guidance to explain how these risk factors are used in the auditor's risk assessment process?
 - (c) In your view, will the introduction of the 'spectrum of inherent risk' (and the related concepts of assessing the likelihood of occurrence, and magnitude, of a possible misstatement) assist in achieving greater consistency in the identification and assessment of the risks of material misstatement, including significant risks?
 - (d) Do you support the introduction of the new concepts and related definitions of significant classes of transactions, account balances and disclosures, and their relevant assertions? Is there sufficient guidance to explain how they are determined (i.e., an assertion is relevant when there is a reasonable possibility of occurrence of a misstatement that is material with respect to that assertion),⁶ and how they assist the auditor in identifying where risks of material misstatement exist?
 - (e) Do you support the revised definition,⁷ and related material, on the determination of 'significant risks'? What are your views on the matters presented in paragraph 57 of the IAASB's Explanatory Memorandum relating to how significant risks are determined on the spectrum of inherent risk?
7. Do you support the additional guidance in relation to the auditor's assessment of risks of material misstatement at the financial statement level,⁸ including the determination about how, and the degree to which, such risks may affect the assessment of risks at the assertion level?
8. What are your views about the proposed stand-back requirement in paragraph 52 of ED 01/18 and the proposed revisions made to paragraph 18 of ASA 330 and its supporting application material? Should either or both requirements be retained? Why or why not?

Request for General Comments

9. In addition to the requests for specific comments above, the AUASB is also seeking comments on the matter set out below:
- (a) **Effective Date**—Recognising that ED 01/18 is a substantive revision, and given the need for national due process, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods beginning at

⁴ Paragraphs 45-50 and A201-A235 of ED 01/18.

⁵ See paragraph 48 of the IAASB's Explanatory Memorandum and paragraphs 16(f), A5-A6 and A83-A88 of ED 01/18.

⁶ See footnote 26 of the IAASB's Explanatory Memorandum.

⁷ Paragraphs 16(k) and A10, and A229-A231 of ED 01/18.

⁸ Paragraphs 47 and A215-A220 of ED 01/18.

least 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged.

Australian specific questions

The AUASB asks the constituents view on:

10. Have applicable laws and regulations been appropriately addressed in the proposed standard?
11. Are there any references to relevant laws or regulations that have been omitted?
12. Whether there are any laws or regulations that may, or do, prevent or impede the application of the proposed standard, or may conflict with the proposed standard?
13. What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the main changes to the requirements of this proposed standard? If significant costs are expected, the AUASB would like to understand:
 - (a) Where those costs are likely to occur;
 - (b) The estimated extent of costs, in percentage terms; and
 - (c) Whether expected costs outweigh the benefits to the users of audit services?
14. Are there any other significant public interest matters that constituents wish to raise?

The AUASB prefers that respondents express a clear opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on the above matters. The AUASB regards both supportive and critical comments as essential to a balanced review of the proposed Auditing Standard.

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes this Auditing Standard ASA 315 *Identifying and Assessing the Risks of Material Misstatement* pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001* and section 336 of the *Corporations Act 2001*.

This Auditing Standard is to be read in conjunction with ASA 101 *Preamble to Australian Auditing Standards*, which sets out the intentions of the AUASB on how the Australian Auditing Standards, operative for financial reporting periods commencing on or after 1 January 2010, are to be understood, interpreted and applied. This Auditing Standard is to be read also in conjunction with ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*.

Conformity with International Standards on Auditing

This Auditing Standard conforms with proposed International Standard on Auditing ISA 315 *Identifying and Assessing the Risks of Material Misstatement* issued by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board of the International Federation of Accountants (IFAC).

Paragraphs that have been added to this Auditing Standard (and do not appear in the text of the equivalent ISA) are identified with the prefix “Aus”.

This Auditing Standard incorporates terminology and definitions used in Australia.

The equivalent requirements and related application and other explanatory material included in proposed ISA 315 in respect of “relevant ethical requirements”, have been included in Auditing Standard, ASA 102 *Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements*. There is no international equivalent to ASA 102.

Compliance with this Auditing Standard enables compliance with ISA 315.

AUDITING STANDARD ASA 315

Identifying and Assessing the Risks of Material Misstatement

Application

- Aus 0.1 This Auditing Standard applies to:
- (a) an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with the *Corporations Act 2001*; and
 - (b) an audit of a financial report, or a complete set of financial statements, for any other purpose.
- Aus 0.2 This Auditing Standard also applies, as appropriate, to an audit of other historical financial information.

Operative Date

- Aus 0.3 This Auditing Standard is operative for financial reporting periods commencing on or after 15 December 2020.

Introduction

Scope of this Auditing Standard

1. This Auditing Standard deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial report.

Key Concepts in this ASA

2. ASA 200 deals with the overall objectives of the auditor in conducting an audit of the financial report,⁹ including to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.¹⁰ Audit risk is a function of the risks of material misstatement and detection risk. ASA 200 explains that the risks of material misstatement may exist at two levels:¹¹ the overall financial statement level; and the assertion level for classes of transactions, account balances and disclosures. ASA 200 further requires the auditor to exercise professional judgement in planning and performing an audit, and to plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial report to be materially misstated.¹²
3. Risks at the financial statement level relate pervasively to the financial report as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level consist of two components, inherent and control risk:
 - Inherent risk is described as the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
 - Control risk is described as the risk that a misstatement that could occur in an assertion about a class of transactions, account balance or disclosure and that could be

⁹ See ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*.

¹⁰ See ASA 200, paragraph 17.

¹¹ See ASA 200, paragraphs 13(c) and 13(n).

¹² See ASA 200, paragraphs 15–16.

material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's controls.

4. The required understanding of the entity and the environment, the applicable financial reporting framework, and the system of internal control forms the basis for the auditor's identification of risks of material misstatement. The identification of risks of material misstatement at the assertion level is performed before consideration of any controls. The auditor does so based on a preliminary assessment of inherent risk that involves identifying those risks for which there is a reasonable possibility of material misstatement. In this ASA the assertions to which such risks of material misstatement relate are referred to as 'relevant assertions,' and the classes of transactions, account balances and disclosures to which the relevant assertions relate are referred to as 'significant classes of transactions, account balances and disclosures.'
5. For the identified risks of material misstatement at the assertion level, a separate assessment of inherent risk and control risk is required by this ASA. The auditor assesses the inherent risk by assessing the likelihood and magnitude of material misstatement, and by taking into account inherent risk factors. Inherent risk factors individually or in combination increase inherent risk to varying degrees. As explained in ASA 200, inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. The degree to which inherent risk varies, is referred to in this ASA as the 'spectrum of inherent risk.'
6. In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls (that is, control risk is assessed as less than maximum). The auditor's understanding of the system of internal control forms the basis for the auditor's intentions about whether to place reliance on the operating effectiveness of controls. That is, the auditor may identify specific controls that address the identified risks of material misstatement and for which the auditor intends to test operating effectiveness. If the auditor does not intend to test the operating effectiveness of controls related to certain identified risks of material misstatement, the auditor's assessment of control risk cannot be reduced for the effective operation of controls with respect to the particular assertion (that is, control risk is assessed at maximum).
7. The auditor's assessment of the risks of material misstatement at the assertion level is based on the auditor's assessments of inherent risk and control risk at the assertion level. The auditor designs and performs further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement at the assertion level. The auditor also identifies and assesses the risks of material misstatement at the financial statement level in accordance with this ASA in order to design and implement overall responses to address such risks.
8. Risks of material misstatement identified and assessed by the auditor include both those due to error and those due to fraud. Although both are addressed by this ASA, the significance of fraud is such that further requirements and guidance are included in ASA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify, assess and respond to the risks of material misstatement due to fraud.

The iterative nature of the auditor's risk assessment process

9. The auditor's risk assessment process is iterative and dynamic. The auditor develops initial expectations about the potential risks of material misstatement and the potential significant classes of transactions, account balances and disclosures based on the auditor's understanding of the entity and its environment and the applicable financial reporting framework. The auditor's understanding of the system of the internal control, and in particular the information system component, provides further information to assist the auditor in developing those expectations.

10. After identifying the risks of material misstatement, the auditor determines the significant classes of transactions, account balances and disclosures. The auditor is also required to perform a stand-back to confirm that this identification is appropriate.
11. The auditor's process of assessing the identified risks of material misstatement at the assertion level also results in the auditor's determination of any significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence.
12. This ASA requires the auditor to revise the risk assessments and modify further overall responses and further audit procedures based on audit evidence obtained from performing further audit procedures, or if new information is obtained.

Scalability

13. ASA 200 states that the Australian Auditing Standards include considerations specific to smaller entities within the application and explanatory material.¹³ This ASA is intended for audits of all entities, regardless of size or complexity. However, the application material of this ASA incorporates considerations specific to audits of smaller entities when such entities are also less complex. Accordingly, in this context, this ASA refers to 'smaller and less complex entities.' While the size of an entity may be an indicator of its complexity, some smaller entities may be complex and some larger entities may be less complex. Some of the considerations however may be useful in audits of larger and less complex entities.

Effective Date

14. [Deleted by the AUASB. Refer Aus 0.3]

Objective

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

Definitions

16. For the purposes of this Auditing Standard, the following terms have the meanings attributed below:
 - (a) Application controls – Controls of a preventative or detective nature that support the initiation, recording, processing and reporting of transactions or other information in the entity's information system, the objectives of which are to maintain the reliability of such transactions and other information. Such controls may rely on information, or other controls that maintain the integrity of information, or may rely on the operation of other controls.
 - (b) Assertions – Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial report which are inherent in management representing that the financial report is prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and in responding to the risks of material misstatement. (Ref: Para: A1-A2).
 - (c) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its

¹³ See ASA 200, paragraphs 66-68.

objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

- (d) Controls – Policies or procedures that are embedded within the components of the system of internal control to achieve the control objectives of management or those charged with governance. In this context:
 - Policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.
 - Procedures are actions to implement policies. (Ref: Para. A3-A4)
- (e) General information technology (IT) controls – Controls related to the IT environment that support the effective functioning of application controls or the integrity of information by helping to maintain the continued operation, as designed, of the entity's information system. General IT controls include controls over the entity's IT processes. Also see the definition of *IT environment*
- (f) Inherent Risk Factors – Characteristics of events or conditions that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or fraud. (Ref: Para A5-A6)
- (g) IT environment – The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. For the purposes of this ASA:
 - An IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information.
 - The IT infrastructure is comprised of the network, operating systems, and databases and their related hardware and software.
 - The IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations, which includes monitoring the IT environment. (Ref: Para: A7-A8)
- (h) Relevant assertions – An assertion is relevant to a class of transactions, account balance or disclosure when the nature or circumstances of that item are such that there is a reasonable possibility of occurrence of a misstatement with respect to that assertion that is material, individually or in combination with other misstatements. There is such possibility when the likelihood of a material misstatement is more than remote. The determination of whether an assertion is a relevant assertion is made before consideration of controls. (Ref: Para. A9)
- (i) Risk assessment procedures – The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
- (j) Significant class of transactions, account balance or disclosure – A class of transactions, account balance or disclosure for which there is one or more relevant assertions.
- (k) Significant risk – An identified risk of material misstatement:

- For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which one or a combination of the inherent risk factors affect the likelihood of a misstatement occurring or the magnitude of potential misstatement should that misstatement occur; or
 - That is to be treated as a significant risk in accordance with the requirements of other Australian Auditing Standards.¹⁴ (Ref: Para. A10)
- (l) System of Internal Control – The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For the purposes of the Australian Auditing Standards, the system of internal control consists of five inter-related components: (Ref: Para. A11)
- Control environment.
 - The entity's risk assessment process.
 - The entity's process to monitor the system of internal control.
 - The information system and communication.
 - Control activities.

Requirements

Risk Assessment Procedures and Related Activities

17. The auditor shall design and perform risk assessment procedures to obtain an understanding of:
- (a) The entity and its environment in accordance with paragraph 23(a);
 - (b) The applicable financial reporting framework in accordance with paragraph 23(b); and
 - (c) The entity's system of internal control in accordance with paragraphs 25–44
- to obtain sufficient appropriate audit evidence as the basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A12-A16)
18. The risk assessment procedures shall include the following: (Ref: Para A17-A20)
- (a) Enquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgement may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A21-A29)
 - (b) Analytical procedures. (Ref: Para. A30-A34)
 - (c) Observation and inspection. (Ref: Para A35-A36)

¹⁴ See ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*, paragraph 27 and ASA 550 *Related Parties*, paragraph 18.

19. The auditor, in identifying and assessing the risks of material misstatement, shall take into account information obtained from the auditor's acceptance or continuance of the client relationship or the audit engagement. (Ref: Para. A37)
20. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying and assessing risks of material misstatement. (Ref: Para. A38)
21. Where the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall evaluate whether such information remains relevant and reliable as audit evidence for the current audit. (Ref: Para. A39-A40)
22. The engagement partner and other key engagement team members shall discuss the application of the applicable financial reporting framework in the context of the nature and circumstances of the entity and its environment, and the susceptibility of the entity's financial report to material misstatement. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A41-A46)

Obtaining an Understanding of the Entity and Its Environment and the Applicable Financial Reporting Framework (Ref: Para. A47-A48)

23. The auditor shall perform risk assessment procedures to obtain an understanding of the entity and its environment and the applicable financial reporting framework. In doing so, the auditor shall obtain an understanding of the following matters to provide an appropriate basis for understanding the classes of transactions, account balances and disclosures to be expected in the entity's financial report:
 - (a) The entity and its environment, including:
 - (i) The entity's organisational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT; (Ref: Para A49-A63)
 - (ii) Relevant industry, regulatory and other external factors; and (Ref: Para. A64-A69)
 - (iii) The relevant measures used, internally and externally, to assess the entity's financial performance. (Ref: Para. A70-A78)
 - (b) The applicable financial reporting framework, including: (Ref: Para.A79-A82)
 - (i) How it applies in the context of the nature and circumstances of the entity and its environment, including how events or conditions are subject to, or affected by, the inherent risk factors; and (Ref: Para.A83-A88)
 - (ii) The entity's accounting policies and any changes thereto, including the reasons for any such changes.
24. The auditor shall evaluate whether the entity's accounting policies, and any changes thereto, are appropriate in the context of the nature and circumstances of the entity and its environment, and consistent with the applicable financial reporting framework.

Obtaining an Understanding of the Entity's System of Internal Control

25. The auditor shall perform risk assessment procedures to obtain an understanding of the entity's system of internal control relevant to financial reporting, including the entity's use of IT, by understanding each of the components of internal control. For this purpose, the auditor shall address the requirements set out in paragraphs 27 to 38 of this ASA. (Ref: Para. A89-A103)

26. The auditor shall identify controls relevant to the audit, and shall evaluate the design of such controls and determine whether the controls have been implemented in accordance with the requirements set out in paragraphs 39 to 42. (Ref: Para. A104)

Components of the Entity's System of Internal Control

Control Environment

27. The auditor shall obtain an understanding of the control environment relevant to financial reporting, including understanding how the entity: (Ref: Para. A105-A110)
- (a) Demonstrates a commitment to integrity and ethical values;
 - (b) When those charged with governance are separate from management, demonstrates that those charged with governance are independent of management and exercise oversight of the entity's system of internal control;
 - (c) Establishes, with the oversight of those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities, in pursuit of its objectives;
 - (d) Demonstrates a commitment to attract, develop, and retain competent individuals in alignment with its objectives; and
 - (e) Holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control.
28. Based on the auditor's understanding of the control environment in accordance with paragraph 27, the auditor shall evaluate whether: (Ref: Para. A111-A114)
- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour; and
 - (b) The strengths in those areas of the entity's control environment addressed in paragraphs 27(a) to (e) collectively provide an appropriate foundation for the other components of the system of internal control, or whether those other components are undermined by control deficiencies in the control environment component.

The Entity's Risk Assessment Process (Ref: Para. A115-A116)

29. The auditor shall obtain an understanding of the entity's risk assessment process, including the extent to which it is formalised, by understanding: (Ref: Para. A117-A119)
- (a) Whether, and if so, how, the entity's process:
 - (i) Identifies business risks relevant to financial reporting objectives;
 - (ii) Assesses the significance of those risks, including the likelihood of their occurrence; and
 - (iii) Addresses those risks.
 - (b) The results of the entity's process.
30. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether any such risks are of a kind that the auditor expects would have been identified by the entity's risk assessment process. If so, the auditor shall obtain an understanding of why the entity's risk assessment process failed to identify such risks of material misstatement, and consider the implications for the auditor's evaluation required by paragraph 31.

Proposed Auditing Standard ASA 315
Identifying and Assessing the Risks of Material Misstatement

31. Based on the auditor's understanding of the entity's risk assessment process in accordance with paragraph 29, and if applicable, paragraph 30, the auditor shall: (Ref: Para. A120-A121)
- (a) Evaluate whether the nature of the entity's risk assessment process, including its formality, is appropriate to the entity's circumstances considering the nature and size of the entity; and
 - (b) If not, determine whether the lack of an appropriate risk assessment process represents one or more control deficiencies.

The entity's process to monitor the system of internal control (Ref: Para. A122-A125)

32. The auditor shall obtain an understanding of the entity's process to monitor the system of internal control, including the extent to which it is formalised, by understanding how the entity's process: (Ref: Para. A126-A128)
- (a) Monitors the effectiveness of controls; and
 - (b) Addresses the identification and remediation of control deficiencies, including those related to the entity's risk assessment process.
33. The auditor shall obtain an understanding of the sources of the information used in the entity's process to monitor the system of internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A129-A130)
34. If the entity has an internal audit function,¹⁵ the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organisational status, and the activities performed, or to be performed. (Ref: Para. A131-A135)

The Information System and Communication

35. The auditor shall obtain an understanding of the information system relevant to financial reporting, including the related business processes, through understanding: (Ref: Para. A136-A141)
- (a) How information relating to significant classes of transactions, account balances and disclosures flows through the entity's information system, whether manually or using IT, and whether obtained from within or outside of the general ledger and subsidiary ledgers. This understanding shall include how: (Ref: Para. A142-A143)
 - (i) Transactions are initiated, and how information about them is recorded, processed, corrected as necessary, and incorporated in the general ledger and reported in the financial report; and
 - (ii) Information about events and conditions, other than transactions, is captured, processed and disclosed in the financial report.
 - (b) The accounting records, specific accounts in the financial report and other supporting records relating to the flows of information in paragraph 35(a);
 - (c) The financial reporting process used to prepare the entity's financial report from the records described in paragraph 35(b), including as it relates to disclosures and to accounting estimates relating to significant classes of transactions, account balances and disclosures;

¹⁵ See ASA 610 *Using the Work of Internal Auditors*, paragraph 14(a), defines the term "internal audit function" for purposes of the ASA.

Proposed Auditing Standard ASA 315
Identifying and Assessing the Risks of Material Misstatement

- (d) The entity's IT environment relevant to (a) through (c) above. (Ref: Para. A144-A150 and Para. A180-A182)
- 36. The auditor shall evaluate the design of the information system controls relevant to financial reporting, by understanding how the matters in paragraph 35(a)–(d) are addressed by the entity, and implemented. (Ref: Para. A151-A157)
- 37. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relevant to financial reporting, including: (Ref: Para. A158-A159)
 - (a) Communications between management and those charged with governance; and
 - (b) External communications, such as those with regulatory authorities.

Control Activities

- 38. The auditor shall obtain an understanding of the control activities component by identifying the controls relevant to the audit in the control activities component in accordance with the requirements of paragraphs 39 through 41, and by evaluating their design and determining whether they have been implemented in accordance with paragraph 42. (Ref: Para. A160-A165)

Controls relevant to the audit

- 39. The auditor shall identify controls relevant to the audit, being those: (Ref: Para. A166-A167)
 - (a) That address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; (Ref: Para. A168)
 - (b) That address risks that are identified as a significant risk; (Ref: Para. A169-A173)
 - (c) Over journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments; (Ref: Para. A174-A175)
 - (d) Controls for which the auditor plans to test the operating effectiveness in determining the nature, timing and extent of substantive testing; or (Ref: Para. A176-A178)
 - (e) That, in the auditor's professional judgement, are appropriate to evaluate their design and determine whether they have been implemented to enable the auditor to: (Ref: Para. A179)
 - (i) Identify and assess the risks of material misstatement at the assertion level; or
 - (ii) Design further audit procedures responsive to assessed risks.

Not all controls that are relevant to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgement as to whether a control, individually or in combination with other controls, is identified as being relevant to the audit.

- 40. Based on the understanding obtained in accordance with paragraph 35(d), and the identification of the controls relevant to the audit in accordance with paragraph 39, the auditor shall identify the IT applications and the other aspects of the entity's IT environment that are relevant to the audit. In doing so, the auditor shall take into account whether the IT applications include or address: (Ref: Para. A180-A188)
 - (a) Automated controls that management is relying on and that the auditor has determined to be relevant to the audit;

- (b) Maintenance of the integrity of information stored and processed in the information system that relates to significant classes of transactions, account balances or disclosures;
 - (c) System-generated reports on which the auditor intends to rely on without directly testing the inputs and outputs of such reports; or
 - (d) Controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.
41. For the IT applications and other aspects of the IT environment that are relevant to the audit, the auditor shall identify: (Ref: Para. A189-A193)
- (a) The risks arising from the use of IT; and
 - (b) The general IT controls relevant to the audit.
42. For each control identified as relevant to the audit in accordance with paragraphs 39 and 41, the auditor shall: (Ref: Para. A194-A200)
- (a) Evaluate whether the control is designed effectively to address the risk of material misstatement at the assertion level, or effectively designed to support the operation of other controls; and
 - (b) Determine whether the control has been implemented by performing procedures in addition to enquiry of the entity's personnel.

Control Deficiencies Within the System of Internal Control

43. The auditor shall, in accordance with ASA 265,¹⁶ determine on the basis of the work performed in accordance with this ASA:
- (a) Whether one or more control deficiencies within the system of internal control have been identified; and
 - (b) If so, whether the control deficiencies, individually or in combination, constitute significant control deficiencies.
44. The auditor shall consider the implications for the audit of one or more control deficiencies in the system of internal control, including for:
- (a) The assessment of control risk for risks of material misstatement at the assertion level in accordance with paragraph 50; and
 - (b) Designing and implementing overall responses to address the assessed risks of material misstatement as required by ASA 330.¹⁷

Identifying and Assessing the Risks of Material Misstatement

45. The auditor shall identify the risks of material misstatement and determine whether they exist at: (Ref: Para. A201-A210)
- (a) The financial statement level, by evaluating whether the identified risks relate more pervasively to the financial report as a whole, including potentially affecting many assertions; or (Ref: Para. A207)

¹⁶ See ASA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraphs 7-8.

¹⁷ See ASA 330 *The Auditor's Responses to Assessed Risks*, paragraph 5.

- (b) The assertion level for classes of transactions, account balances, and disclosures, taking into account the inherent risk factors. (Ref: Para. A208)
- 46. The auditor shall determine significant classes of transactions, account balances and disclosures, and their relevant assertions, based on the identified risks of material misstatement. (Ref: Para. A211-A214)

Assessing Risks of Material Misstatement at the Financial Statement Level

- 47. The auditor shall assess the identified risks of material misstatement at the financial statement level by: (Ref: Para. A215-A220)
 - (a) Determining how, and the degree to which, such risks affect the assessment of risks of material misstatement at the assertion level (Ref: Para. A227), and
 - (b) Evaluating the nature and extent of their pervasive effect on the financial report to provide the basis for designing and implementing overall responses to the identified risk of material misstatement at the financial statement level in accordance with ASA 330.¹⁸ (Ref: Para A216)

Assessing Risks of Material Misstatement at the Assertion Level

Assessing Inherent Risk

- 48. For identified risks of material misstatement at the assertion level, the auditor shall assess inherent risk by assessing the likelihood and magnitude of material misstatement. In doing so, the auditor shall take into account how, and the degree to which:
 - (a) Identified events and conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, the inherent risk factors. (Ref: Para. A221-A228)
 - (b) The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (Ref: Para. A216 and A227)
- 49. The auditor shall determine, based on the auditor's assessment of inherent risk, whether any of the assessed risks of material misstatement are significant risks. (Ref: Para. A229-A231)

Assessing Control Risk

- 50. For identified risks of material misstatement at the assertion level, the auditor shall assess control risk as follows: (Ref: Para. A232-A235)
 - (a) When the auditor plans to test the operating effectiveness of controls in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level, the auditor shall assess control risk at less than maximum. In doing so, the auditor shall take into account whether the design, implementation and expected operating effectiveness of such controls support the auditor's intended reliance thereon.
 - (b) When the auditor does not plan to test the operating effectiveness of controls in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level, the auditor shall assess control risk at the maximum.

¹⁸ See ASA 330, paragraph 5.

Proposed Auditing Standard ASA 315
Identifying and Assessing the Risks of Material Misstatement

Risks for Which Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence

51. The auditor shall determine, for any of the risks of material misstatement at the assertion level, whether substantive procedures alone cannot provide sufficient appropriate audit evidence (Ref: Para. A236-A239)

Classes of Transactions, Account Balances and Disclosures that are Not Significant, but which are Material

52. The auditor shall: (Ref: Para. A240-A242)
- (a) Identify the classes of transactions, account balances and disclosures that are quantitatively or qualitatively material, and that have not been identified as significant classes of transactions, account balances or disclosures in accordance with paragraph 46; and
 - (b) Evaluate whether the auditor's conclusion that there are no relevant assertions (that is, no related risks of material misstatement) for these classes of transactions, account balances and disclosures remains appropriate.

Revision of Risk Assessment

53. The auditor's assessments of the risks of material misstatement at the financial statement level and assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the identification and assessments of the risks of material misstatement, the auditor shall revise the assessment and modify the planned overall responses or further audit procedures accordingly. (Ref: Para. A243)

Documentation

54. The auditor shall include in the audit documentation:¹⁹ (Ref: Para. A244-A247)
- (a) The discussion among the engagement team, where required in accordance with paragraph 22, and the significant decisions reached;
 - (b) Key aspects of the auditor's understanding obtained regarding the entity and its environment specified in paragraph 23 and of each of the components of the system of internal control specified in paragraphs 27, 29, 32 through 38; the sources of information from which the auditor's understanding was obtained; and the risk assessment procedures performed;
 - (c) The controls identified to be relevant to the audit in accordance with the requirements in paragraphs 39 and 41.
 - (d) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 45 through 51, including significant risks, and the rationale for the significant judgements made in identifying and assessing the risks of material misstatement. (Ref: Para A245)

¹⁹ See ASA 230 *Audit Documentation*, paragraphs 8-11 and A6-A7.

Application and Other Explanatory Material

Definitions

Assertions (Ref: Para. 16(b))

- A1. Representations by management with respect to the recognition, measurement, presentation and disclosure of information in the financial report of classes of transactions, account balances and disclosures differ from written representations provided to the auditor by management, as required by ASA 580,²⁰ to confirm certain matters or support other audit evidence.
- A2. Assertions that the auditor may use in addressing the requirements of this ASA are further described in paragraph A204.

Controls (Ref: Para. 16(d))

- A3. Policies are implemented through the actions of personnel within the entity, or through their restraint from taking actions that would conflict with such policies.
- A4. Procedures may be mandated, through formal documentation or other communication by management or those charged with governance, or may result from behaviours that are not mandated but are rather conditioned by the entity's culture. Procedures may be enforced through the actions permitted by the IT applications used by the entity or other aspects of the entity's IT environment.

Inherent Risk Factors (Ref: Para. 16(f))

- A5. Inherent risk factors may be qualitative or quantitative and affect the susceptibility to misstatement of financial statement items. Qualitative inherent risk factors relating to the preparation of information required by the applicable financial reporting framework (referred to in this paragraph as "required information") include:
- *Complexity*—arises either from the nature of the information or in the way that the required information is prepared, including when such preparation processes are more inherently difficult to apply. For example, complexity may arise:
 - In calculating supplier rebate provisions because it may be necessary to take into account different commercial terms with many different suppliers, or many interrelated commercial terms that are all relevant in calculating the rebates due; or
 - When there are many potential data sources, with different characteristics used in making an accounting estimate, the processing of that data involves many inter-related steps, and the data is therefore inherently more difficult to identify, capture, access, understand or process.
 - *Subjectivity*—arises from inherent limitations in the ability to prepare required information in an objective manner, due to limitations in the availability of knowledge or information, such that management may need to make an election or subjective judgement about the appropriate approach to take and about the resulting information to include in the financial report. Because of different approaches to preparing the required information, different outcomes could result from appropriately applying the requirements of the applicable financial reporting framework. As limitations in knowledge or data increase, the subjectivity in the judgements that could be made by

²⁰ See ASA 580 *Written Representations*.

reasonably knowledgeable and independent individuals, and the diversity in possible outcomes of those judgements will also increase.

- *Change*—results from events or conditions that, over time, affect the entity’s business or the economic, accounting, regulatory, industry or other aspects of the environment in which it operates, when the effects of those events or conditions are reflected in the required information. Such events or conditions may occur during, or between, financial reporting periods. For example, change may result from developments in the requirements of the applicable financial reporting framework, or in the entity and its business model, or in the environment in which the entity operates. Such change may affect management’s assumptions and judgements, including as they relate to management’s selection of accounting policies or how accounting estimates are made or related disclosures are determined.
- *Uncertainty*—arises when the required information cannot be prepared based only on sufficiently precise and comprehensive data that is verifiable through direct observation. In these circumstances, an approach may need to be taken that applies the best available knowledge to prepare the information using sufficiently precise and comprehensive observable data, to the extent available, and reasonable assumptions supported by the best available data, when it is not. Constraints on the availability of knowledge or data, which are not within the control of management (subject to cost constraints where applicable) are sources of uncertainty and their effect on the preparation of the required information cannot be eliminated. For example, estimation uncertainty arises when the required monetary amount cannot be determined with precision and the outcome of the estimate is not known before the date the financial report is finalised.
- *Susceptibility to misstatement due to management bias or fraud*— results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgement (indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional. Such indicators include inherent incentives or pressures (for example, as a result of motivation to achieve a desired result, such as a desired profit target or capital ratio), and opportunity, not to maintain neutrality. Factors relevant to the susceptibility to misstatement due to fraud for assertions about classes of transactions, account balances and disclosures are described in paragraphs A1 to A5 of ASA 240.

A6. Other inherent risk factors, that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure include:

- The quantitative or qualitative significance of the class of transactions, account balance or disclosure, and of the items in relation to performance materiality;
- The composition of the class of transactions, account balance or disclosure, including whether the items are subject to differing risks;
- The volume of activity and homogeneity of the individual transactions processed through the class of transactions or account balance or class of transactions, or reflected in the disclosure; or
- The existence of related party transactions in the class of transaction or account balance, or that are relevant to the disclosure.

Proposed Auditing Standard ASA 315
Identifying and Assessing the Risks of Material Misstatement

IT Environment (Ref: Para 16(g))

- A7. IT applications may include data warehouses or report writers. A data warehouse is a central repository of integrated data from one or more disparate sources (such as multiple databases) from which reports may be generated or that may be used by the entity for other data analysis activities. A report-writer is an IT application that is used to extract data from one or more sources (such as a data warehouse, a database or an IT application) and present the data in a specified format.
- A8. A network is used in the IT infrastructure to transmit data and to share information, resources and services through a common communications link. The network also typically establishes a layer of logical security (enabled through the operating system) for access to the underlying resources. The operating system is responsible for managing communications between hardware, IT applications, and other software used in the network. Databases store the data used by IT applications and may consist of many interrelated data tables. Data in databases may also be accessed directly through database management systems by IT or other personnel with database administration privileges.

Relevant Assertions (Ref: Para. 16(h))

- A9. There will be one or more risks of material misstatement that relate to a relevant assertion. A risk of material misstatement may relate to more than one assertion, in which case all the assertions to which such a risk relates would be relevant assertions

Significant Risk (Ref: Para. 16(k))

- A10. Significance can be described as the relative importance of a matter, taken in context. The significance of a matter is judged by the auditor in the context in which the matter is being considered. The significance of a risk of material misstatement at the assertion level is considered in the context of the implications of the assessment of its inherent risk for the performance of the audit, including the nature, timing and extent of the auditor's further audit procedures and the persuasiveness of the audit evidence that will be required to reduce audit risk to an acceptable level. Significance can be considered in the context of how, and the degree to which, the susceptibility to misstatement is subject to, or affected by, the inherent risk factors, which affect the likelihood that a misstatement will occur, as well as the potential magnitude of the misstatement were that misstatement to occur.

System of Internal Control (Ref: Para. 16(l))

- A11. The entity's system of internal control may be reflected in policy and procedures manuals, systems and forms, and the information embedded therein, and is effected by people. The system of internal control is implemented by management, those charged with governance, and other personnel based on the structure of the entity. The system of internal control can be applied, based on the decisions of management, those charged with governance and other personnel and in the context of legal or regulatory requirements, to the operating model of the entity, the legal entity structure, or a combination of these.

Risk Assessment Procedures and Related Activities (Ref: Para. 17–22)

Risk Assessment Procedures (Ref: Para. 17)

- A12. Obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control is a dynamic and iterative process of gathering, updating and analysing information and continues throughout the audit. As the auditor performs audit procedures, the audit evidence obtained may cause the auditor to update the understanding on which the risk assessment was based and the nature, timing or extent of other planned audit procedures in accordance with ASA 330. For example, information gathered in understanding the entity's system of internal control assists the auditor in assessing control risk at the assertion level, such that control risk may be assessed at less

than maximum based on an expectation about the operating effectiveness of the control(s) and the planned testing of such control(s). Information gathered when testing the operation of the control(s) as part of performing further audit procedures may indicate that the control(s) are not effective, and as a result the auditor's original assessment is updated in accordance with paragraph 53.

- A13. The risks of material misstatement to be identified and assessed include both those due to fraud and those due to error, and both are covered by this ASA. However, the significance of fraud is such that further requirements and guidance are included in ASA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.²¹ In addition, the following Australian Auditing Standards provide further requirements and guidance on identifying and assessing risks of material misstatement in regard to specific matters or circumstances:
- ASA 540²² in regard to accounting estimates;
 - ASA 550²³ in regard to related party relationships and transactions;
 - ASA 570²⁴ in regard to going concern; and
 - ASA 600²⁵ in regard to group financial report.
- A14. The understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control also establishes a frame of reference within which the auditor plans the audit and exercises professional judgement throughout the audit, for example, when:
- Identifying and assessing risks of material misstatement of the financial report (e.g., relating to risks of fraud in accordance with ASA 240 or when identifying or assessing risks related to accounting estimates in accordance with ASA 540);
 - Determining materiality or performance materiality in accordance with ASA 320;²⁶
 - Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
 - Developing expectations for use when performing analytical procedures in accordance with ASA 520;²⁷
 - Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence in accordance with ASA 330;²⁸ and
 - Evaluating the sufficiency and appropriateness of audit evidence obtained (e.g., relating to assumptions or management's oral and written representations).
- A15. Information obtained by performing risk assessment procedures and related activities in accordance with paragraphs 17 to 22 of this ASA is audit evidence that supports the identification and assessment of the risks of material misstatement. In addition, the auditor may obtain some audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even

²¹ See ASA 240, paragraphs 12-24.

²² See ASA 540 *Auditing Accounting Estimates and Related Disclosures*.

²³ See ASA 550 *Related Parties*.

²⁴ See ASA 570 *Going Concern*.

²⁵ See ASA 600 *Special Considerations – Audits of a Group Financial Report*.

²⁶ See ASA 320 *Materiality in Planning and Performing an Audit*, paragraphs 10-11.

²⁷ See ASA 520 *Analytical Procedures*, paragraph 5.

²⁸ See ASA 330 *The Auditor's Responses to Assessed Risks*.

though such risk assessment procedures were not specifically planned as substantive procedures or as tests of controls. The auditor may also perform designed substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so. For example, through the use of technology the auditor may perform procedures on large volumes of data, and audit evidence may be obtained that provides information that is useful for the identification and assessment of risks of material misstatement, as well as providing sufficient appropriate audit evidence to support the conclusion that the possibility of a material misstatement is remote.

- A16. The auditor uses professional judgement to determine the nature and extent of the required understanding. The auditor's primary consideration is whether the understanding that has been obtained meets the objective stated in this ASA. The auditor's risk assessment procedures to obtain the overall understanding may be less extensive in audits of smaller and less complex entities. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

Types of Risk Assessment Procedures and Sources of Information (Ref: Para. 18)

- A17. ASA 500²⁹ explains the types of audit procedures that may be performed in obtaining audit evidence from risk assessment procedures and further audit procedures. The nature and timing of the audit procedures may be affected by the fact that some of the accounting data and other information may only be available in electronic form or only at certain points in time.³⁰
- A18. Some of the information used by the auditor when performing risk assessment procedures may be electronic data available from the entity's information system, for example the general ledger, sub-ledgers or other operational data. In performing risk assessment procedures, the auditor may use automated tools and techniques in performing the risk assessment procedures, including for analysis, recalculations, reperformance or reconciliations.
- A19. Sources of information available to the auditor may include:
- Information obtained through interactions with management, those charged with governance, and other key entity personnel, such as internal auditors.
 - Information obtained directly or indirectly from certain external parties such as regulators.
 - Information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, updated as appropriate.
 - Publicly available information about the entity, for example entity-issued press releases, and materials for analysts or investor group meetings, analysts' reports or information about trading activity.

These sources may provide potentially contradictory information, which may assist the auditor in exercising professional scepticism in identifying and assessing the risks of material misstatement. Regardless of the source of information, the auditor considers the relevance and reliability of the information to be used as audit evidence in accordance with ASA 500.³¹

- A20. Although the auditor is required to perform all the risk assessment procedures described in paragraph 18 in the course of obtaining the required understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control (see paragraphs 23–44), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of

²⁹ See ASA 500 *Audit Evidence*, paragraphs A14-A17 and A21-A25.

³⁰ See ASA 500, paragraph A12.

³¹ See ASA 500, paragraph 7.

such procedures may include making enquiries of the entity's external legal counsel or external supervisors, or of valuation experts that the entity has used.

Enquiries of Management, the Internal Audit Function and Others within the Entity (Ref: Para. 18(a))

- A21. Much of the information obtained by the auditor's enquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through enquiries of the internal audit function, if the entity has such a function, and others within the entity.
- A22. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through enquiries of others within the entity and other employees with different levels of authority. For example:
- Enquiries directed towards those charged with governance may help the auditor understand the environment in which the financial report is prepared. ASA 260³² identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
 - Enquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
 - Enquiries directed towards in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contractual terms.
 - Enquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
 - Enquiries directed towards the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
 - Enquiries directed towards information system personnel may provide information about system changes, system or control failures, or other information system-related risks.
- A23. As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's enquiries may occur throughout the audit engagement.

Considerations Specific to Public Sector Entities

- A24. When making enquiries of those who may have information that is likely to assist in identifying risks of material misstatement, auditors of public sector entities may obtain information from additional sources such as from the auditors that are involved in performance or other audits related to the entity.

Enquiries of the Internal Audit Function

- A25. If an entity has an internal audit function, enquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control, and in identifying and assessing risks of material misstatement at

³² See ASA 260 *Communication with Those Charged with Governance*, paragraph 4(b).

the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity and its environment, the applicable financial reporting framework and the system of internal control, the auditor's risk assessments or other aspects of the audit. The auditor's enquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.³³ Enquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

- A26. If, based on responses to the auditor's enquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.
- A27. In addition, in accordance with ASA 240,³⁴ if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.
- A28. Appropriate individuals within the internal audit function with whom enquiries are made are those who, in the auditor's judgement, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Considerations specific to public sector entities

- A29. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Enquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of control deficiencies related to financial reporting.

Analytical Procedures (Ref: Para. 18(b))

- A30. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in identifying and assessing the risks of material misstatement. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.
- A31. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- A32. Analytical procedures performed as risk assessment procedures may use data aggregated at a high level and accordingly the results of those analytical procedures may provide a broad initial indication about the likelihood of a material misstatement. For example, in the audit of many entities, including those with less complex business models and processes, and a less complex information system, the auditor may perform a simple comparison of information,

³³ The relevant requirements are contained in ASA 610.

³⁴ See ASA 240, paragraph 19.

such as the change in account balances from interim or monthly reporting with balances from prior periods, to obtain an indication of potentially higher risk areas.

- A33. Analytical procedures can be performed using a number of tools or techniques, which may be automated. Applying automated analytical procedures to the data may be referred to as data analytics. For example, the auditor may use a spreadsheet to perform a comparison of actual recorded amounts to budgeted amounts, or may perform a more advanced procedure by extracting data from the entity's information system, and further analysing this data using visualization techniques to identify more specific areas of possible misstatement.
- A34. This ASA deals with the auditor's use of analytical procedures as risk assessment procedures. ASA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"). Accordingly, analytical procedures performed as risk assessment procedures are not required to be performed in accordance with the requirements of ASA 520. However, the requirements and application material in ASA 520 may provide useful guidance to the auditor when performing analytical procedures as part of the risk assessment procedures.

Observation and Inspection (Ref: Para. 18(c))

- A35. Observation and inspection may support enquiries of management and others, and may also provide information about the entity and its environment. Examples of such risk assessment procedures include observation or inspection of the following:
- The entity's operations.
 - Internal documents (such as business plans and strategies), records, and internal control manuals.
 - Reports prepared by management (such as quarterly management reports and interim financial report) and those charged with governance (such as minutes of board of directors' meetings).
 - The entity's premises and plant facilities.
 - Information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications; or other external documents about the entity's financial performance (such as those referred to in paragraph A74).
 - The behaviours and actions of management or those charged with governance (such as the observation of an audit committee meeting).

Considerations specific to public sector entities

- A36. Risk assessment procedures performed by auditors of public sector entities may also include observation and inspection of documents prepared by management for the legislature, for example as documents related to mandatory performance reporting.

Information from the Acceptance or Continuance of the Client Relationship or the Audit Engagement
(Ref: Para. 19)

- A37. In accordance with ASA 220, the engagement partner is required to be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and to determine that conclusions reached in this regard are appropriate.³⁵ Information obtained in the client and engagement acceptance or

³⁵ See ASA 220 *Quality Control for an Audit of a Financial Report and Other Historical Financial Information*, paragraph 12.

continuance process may be relevant to the identification and assessment of the risks of material misstatement. Examples may include:

- Information about the nature of the entity and its business risks.
- Information about the integrity and ethical values of management and those charged with governance, which may be relevant to the auditor's understanding of the control environment, and may also affect the auditor's identification and assessment of the risks of material misstatement at the financial statement level.
- The applicable financial reporting framework and information about its application to the nature and circumstances of the entity.

Information from Other Engagements Performed for the Entity (Ref: Para. 20)

- A38. The engagement partner may have performed other engagements for the entity and may thereby have obtained knowledge relevant to the audit, including about the entity and its environment. Such engagements may include agreed-upon procedures engagements (e.g., agreed-upon procedures relating to an entity's debt covenant compliance) or other audit or assurance engagements (e.g., audits of special purpose financial report or reviews of interim financial information).

Information Obtained in Prior Periods (Ref: Para. 21)

- A39. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:
- Past misstatements and whether they were corrected on a timely basis.
 - The nature of the entity and its environment, and the entity's system of internal control (including control deficiencies).
 - Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
 - Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity.
- A40. The auditor is required to determine whether information obtained in prior periods remains relevant and reliable, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the entity's system of internal control, for example, may affect the relevance and reliability of information obtained in the prior period. In evaluating whether such information remains relevant and reliable for the current audit, the auditor may consider whether changes have occurred that may affect the relevance or reliability of such information. For example, the auditor may make enquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion Among the Engagement Team (Ref: Para. 22)

- A41. Paragraph 22 requires the engagement partner and other key engagement team members to discuss the application of the applicable financial reporting framework in the context of the nature and circumstances of the entity and its environment, and the susceptibility of the entity's financial report to material misstatement. When the engagement is carried out by a single individual (such as a sole practitioner) i.e., where an engagement team discussion would not be possible, consideration of the matters referred to in paragraphs A42 and A43 nonetheless may assist the auditor in identifying where there may be risks of material misstatement.

A42. The discussion among the engagement team about the susceptibility of the entity's financial report to material misstatement:

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

ASA 240 requires the engagement team discussion to place particular emphasis on how and where the entity's financial report may be susceptible to material misstatement due to fraud, including how fraud may occur.³⁶

A43. As part of the discussion among the engagement team required by paragraph 22, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures, even in circumstances where the applicable financial reporting framework only requires simplified disclosures. Examples of matters the engagement team may discuss include:

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

A44. In addition to the intended benefits of the engagement team discussion included in paragraph A42, the engagement team may also have an opportunity to exercise professional scepticism while performing risk assessment procedures, such as through identifying and discussing contradictory information obtained in performing those procedures, as well as in considering whether there are indicators of possible management bias (both intentional and unintentional). Professional scepticism is necessary for the critical assessment of audit evidence, and a robust and open engagement team discussion, including for recurring audits,

³⁶ See ASA 240, paragraph 15.

may lead to improved identification and assessment of the risks of material misstatement. Another outcome from the discussion may be that the auditor identifies specific areas of the audit for which exercising professional scepticism may be particularly important, which may in turn drive the consideration of those engagement team members who are appropriately skilled to be involved in the performance of audit procedures related to those areas.

- A45. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, while taking into account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Public Sector Entities

- A46. As part of the discussion among the engagement team, as required by paragraph 22, by auditors of public sector entities, consideration may also be given to any additional broader objectives, and related risks, arising from the audit mandate or obligations for public sector entities.

Obtaining an Understanding of the Entity and Its Environment and the Applicable Financial Reporting Framework (Ref: Para. 23-24)

- A47. The auditor's understanding of the entity and its environment, and the applicable financial reporting framework, establishes a frame of reference within which the auditor identifies and assesses risks of material misstatement, and plans and performs audit procedures. Specifically, the auditor applies professional judgement in determining whether the understanding required by paragraph 23 is sufficient to provide an appropriate basis for the auditor to understand the classes of transactions, account balances and disclosures to be expected in the entity's financial report. This understanding assists the auditor in identifying areas in the financial report where material misstatements may be more likely to arise and assists the auditor in exercising professional scepticism throughout the audit. The nature and extent of the understanding required will likely depend on the nature, size and complexity of the entity.

The Entity and Its Environment (Ref: Para 23(a))

- A48. In obtaining an understanding of the entity and its environment, the auditor may be able to enhance the understanding by using automated tools and techniques. For example, the auditor may use automated techniques to understand flows of transactions and processing as part of the auditor's procedures to understand the information system. An outcome of these procedures may be that the auditor obtains information about the entity's organisational structure or those with whom the entity conducts business (e.g., vendors, customers, related parties).

The Entity's Organisational Structure, Ownership and Governance, and Business Model (Ref: Para. 23(a)(i))

The entity's organisational structure and ownership

- A49. An understanding of the entity's organisational structure and ownership may enable the auditor to understand such matters as:
- The complexity of the entity's structure. For example, the entity may be a single entity or the entity's structure may include subsidiaries, divisions or other components in multiple locations. Further, the legal structure may be different from the operating structure. Complex structures often introduce factors that may give rise to increased

susceptibility to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately and whether adequate disclosure of such issues in the financial report have been made.

- The ownership, and relationships between owners and other people or entities, including related parties. This understanding may assist in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial report.³⁷
- The distinction between the owners, those charged with governance and management. In some entities, particularly smaller and less complex entities, owners of the entity may be involved in managing the entity, or those charged with governance may be involved in managing the entity.³⁸
- The entity's IT environment. For example, an entity's IT environment may be relatively simple because it consists only of commercial software for which the entity does not have access to the underlying source code to which no changes have been made. Alternatively, an entity may have grown through extensive merger and acquisition activity and have multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment.

Considerations specific to public sector entities

- A50. In obtaining an understanding of the entity's organisational structure and ownership, auditors of public sector entities may consider the relevance of ownership of a public sector entity (i.e., ownership of a public sector entity may not have the same relevance as in the private sector because decisions related to the entity may be initiated outside of the entity as a result of political processes and therefore management may not have control over decisions that are made). Matters related to the understanding of the organisational structure, governance and business model of a public sector entity may include understanding the ability of the entity to make unilateral decisions, and the ability of other public sector entities to control or influence the entity mandate and strategic direction. For example, the public sector entity may be subject to laws or other directives from authorities that require it to obtain approval from parties external to the entity of its strategy and objectives prior to it implementing them. Matters related to understanding the legal structure of the entity may include applicable laws and regulations, and the classification of the entity (i.e. whether the entity is a ministry, department, agency or other type of entity).

Governance

- A51. Responsibilities of management and those charged with governance are broader than responsibilities for the oversight of the system of internal control, but are generally prerequisites for an effective system of internal control. The responsibilities of those charged with governance in relation to the control environment are further discussed in Appendix 3. Deficient governance processes may limit an entity's ability to provide appropriate oversight of its system of internal control, which may increase the entity's susceptibility to risks of material misstatement. Matters that may be relevant for the auditor to consider in obtaining an understanding of the governance of the entity include:
- Whether any or all of those charged with governance are involved in managing the entity.

³⁷ ASA 550 establishes requirements and provide guidance on the auditor's considerations relevant to related parties.

³⁸ ASA 260, paragraphs A1 and A2, provides guidance on the identification of those charged with governance and explains that in some cases, some or all of those charged with governance are involved in managing the entity.

- The existence (and separation) of a non-executive Board, if any, from executive management.
- Whether those charged with governance hold positions that are an integral part of the entity's legal structure, for example as directors.
- The existence of sub-groups of those charged with governance such as an audit committee, and the responsibilities of such a group.
- The responsibilities of those charged with governance for oversight of financial reporting, including approval of the financial report.

The Entity's Business Model

- A52. The auditor's understanding of the entity's business model, and how it is affected by its business strategy and business objectives, may assist the auditor in identifying business risks that are relevant in the context of the audit. Furthermore, this may assist the auditor in identifying risks of material misstatement. For example, incentives and pressures on management may result in intentional or unintentional management bias, which may affect the reasonableness of significant assumptions and expectations of management or those charged with governance thereby increasing the susceptibility to risks of material misstatement. (See also paragraph A59).
- A53. An entity's business model describes how an entity considers, for example its organisational structure, operations or scope of activities, business lines (including competitors and customers thereof), processes, growth opportunities, globalization, regulatory requirements and technologies. The entity's business model describes how the entity creates, preserves and captures financial or broader value, such as public benefits, for its stakeholders.
- A54. Strategies are the approaches by which management plans to achieve the entity's objectives, including how the entity plans to address the risks and opportunities that it faces. An entity's strategies are changed over time by management, to respond to changes in its objectives and in the internal and external circumstances in which it operates.
- A55. A description of a business model typically includes:
- The scope of the entity's activities, and why it does them.
 - The entity's structure and scale of its operations.
 - The markets or geographical or demographic spheres, and parts of the value chain, in which it operates, how it engages with those markets or spheres (main products, customer segments and distribution methods), and the basis on which it competes.
 - The entity's business or operating processes (e.g., investment, financing and operating processes) employed in performing its activities, focusing on those parts of the business processes that are important in creating, preserving or capturing value.
 - The resources (e.g., financial, human, intellectual, environmental and technological) and other inputs and relationships (e.g., customers, competitors, suppliers and employees) that are necessary or important to its success.
 - How the entity's business model integrates the use of IT in its interactions with customers, suppliers, lenders and other stakeholders through IT interfaces and other technologies.
- A56. Understanding the entity's objectives, strategy and business model helps the auditor to understand the entity at a strategic level and to understand the business risks the entity takes and faces. Not all aspects of the business model are relevant for the auditor's understanding,

but those aspects that give rise to business risks, which are relevant to the identification and assessment of risks of material misstatement, are likely to be more relevant for the auditor's understanding.

- A57. Appendix 1 provides examples of matters that may be considered when obtaining an understanding of the activities of the entity, as well as other matters that may be considered when auditing financial report of special purpose entities.

Considerations specific to public sector entities

- A58. Entities operating in the public sector may create and deliver value in different ways to those creating wealth for owners, but will still have a 'business model' to promote value in the public interest. Matters public sector auditors may obtain an understanding of that are relevant to the business model of the entity, include:

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

Business risks in the context of the entity's business model

- A59. An understanding of the business risks that have an effect on the financial report assists the auditor in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial report. Business risks are broader than the risks of material misstatement of the financial report, although business risks includes the latter. The auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement. Business risk may arise from, among other matters, inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity. A failure to recognise the need for change may also give rise to business risk, for example, from:

- The development of new products or services that may fail;
- A market which, even if successfully developed, is inadequate to support a product or service; or
- Flaws in a product or service that may result in legal liability and reputational risk.

- A60. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a significant fall in real estate market values may increase the risk of material misstatement associated with the valuation assertion for a lender of medium-term real estate backed loans. However, the same risk, particularly in combination with a severe economic downturn that concurrently increases the underlying risk of lifetime credit losses on its loans, may also have a longer-term consequence. The resulting net exposure to credit losses may cast significant doubt on the entity's ability to continue as a going concern. If so, this could have implications for management's and the auditor's conclusion as to the appropriateness of the entity's use of the going concern basis of accounting and determination as to whether a material uncertainty exists. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of events and conditions that may indicate risks of material misstatement are indicated in Appendix 2.

- A61. Examples of matters that the auditor may consider when obtaining an understanding of the entity's business model, objectives, strategies and related business risks that may result in a risk of material misstatement of the financial report include:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that the entity is implementing a new IT system that will affect both operations and financial reporting).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A62. Ordinarily, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of the entity's system of internal control and is discussed in paragraph 29–31 and paragraphs A115–A121.

Considerations Specific to Public Sector Entities

A63. For the audits of public sector entities, “management objectives” may be influenced by requirements to demonstrate public accountability and may include objectives which have their source in law, regulation or other authority.

Relevant Industry, Regulatory and Other External Factors (Ref: Para. 23(a)(ii))

Industry factors

A64. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

- The market and competition, including demand, capacity, and price competition.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

A65. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise

to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience.³⁹

Regulatory Factors

A66. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment and any changes thereto. Examples of matters the auditor may consider include:

- Regulatory framework for a regulated industry, for example, medical or retirement funds, including requirements for disclosures.
- Legislation and regulation that significantly affect the entity's operations, for example, labour laws and regulations.
- Taxation legislation and regulations.
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restriction policies.
- Environmental requirements affecting the industry and the entity's business.

A67. ASA 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.⁴⁰

Considerations specific to public sector entities

A68. For the audits of public sector entities, there may be particular laws or regulations that affect the entity's operations. Such elements may be an essential consideration when obtaining an understanding of the entity and its environment.

Other External Factors

A69. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Relevant Measures Used to Assess the Entity's Financial Performance (Ref: Para. 23(a)(iii))

A70. Management and others ordinarily measure and review those matters they regard as important. The procedures undertaken to measure the relevant performance of the entity may vary depending on the size or complexity of the entity, as well as the involvement of owners or those charged with governance in the management of the entity.

A71. Performance measures, whether used externally or internally, may create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to intentionally misstate the financial report. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the susceptibility to misstatement due to management bias or fraud. For example, the auditor may identify incentives or pressures that may increase the risk of management override of controls. See ASA 240 for requirements and guidance in relation to the risks of fraud.

³⁹ See ASA 220, paragraph 14.

⁴⁰ See ASA 250 *Consideration of Laws and Regulations in an Audit of a Financial Report*, paragraph 13.

A72. The measurement and review of financial performance is not the same as the monitoring of the system of internal control (discussed as a component of the system of internal control in paragraphs A122–A135), though their purposes may overlap:

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

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

A73. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

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

A74. External parties may also review and analyse the entity's financial performance, in particular for entities where financial information is publicly available. For example, publicly available financial information may be issued by:

- Analysts or credit agencies.
- Revenue authorities.
- Regulators.
- Trade unions.
- Providers of finance.

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

A75. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor the likelihood with which risks of misstatement of related financial statement information exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry.

A76. Performance measures and targets, whether imposed internally or externally, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate an increased susceptibility to misstatement due to management bias or fraud in the preparation of the financial report.

A77. Enquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. In such cases, the auditor may identify

relevant performance measures, whether internal or external, by considering the information that the entity uses to manage its business. If such enquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

Considerations specific to public sector entities

A78. In addition to considering relevant measures used by a public sector entity to assess the entity's financial performance, auditors of public sector entities may also consider non-financial information such as achievement of public benefit outcomes (for example, the number of people assisted by a specific program).

The Applicable Financial Reporting Framework (Ref: Para. 23(b))

A79. Examples of matters that the auditor may consider when obtaining an understanding of the entity's applicable financial reporting framework, and how it applies in the context of the nature and circumstances of the entity and its environment include:

- The entity's financial reporting practices in terms of the applicable financial reporting framework, such as:
 - Accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances and related disclosures in the financial report (for example, loans and investments for banks, or research and development for pharmaceuticals).
 - Revenue recognition.
 - Accounting for financial instruments, including related credit losses.
 - Foreign currency assets, liabilities and transactions.
 - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for share-based payments).
- An understanding of the entity's selection and application of accounting policies, including any changes thereto as well as the reasons therefore, may encompass such matters as:
 - The methods the entity uses to recognise, measure, present and disclose significant and unusual transactions.
 - The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
 - Changes in the environment, such as changes in the applicable financial reporting framework or tax reforms that may necessitate a change in the entity's accounting policies.
 - Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt, or comply with, such requirements.

A80. Obtaining an understanding of the entity and its environment assists the auditor in considering where changes in the entity's financial reporting (e.g., from prior periods) may be expected. For example, if the entity has had a significant business combination during the period, the auditor would likely expect changes in classes of transactions, account balances and disclosures associated with that business combination. Alternatively, if there were no significant changes in the financial reporting framework during the period the auditor's

understanding may help confirm that the understanding obtained in the prior period remains applicable.

- A81. Disclosures in the financial report of smaller and less complex entities may be simpler and less detailed (e.g., some financial reporting frameworks allow smaller entities to provide simpler and less detailed disclosures in the financial report). However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment, the applicable financial reporting framework as it applies to the entity, and its related system of internal control.

Considerations specific to public sector entities

- A82. The applicable financial reporting framework in a public sector entity is determined by the legislative and regulatory frameworks relevant to each jurisdiction or within each geographical area. Matters that may be considered in the entity's application of the applicable financial reporting requirements, and how it applies in the context of the nature and circumstances of the entity and its environment, include whether the entity applies a full accrual-basis of accounting (such as the International Public Sector Accounting Standards), a cash-basis of accounting, or a hybrid. The financial reporting applied by a public sector entity further impacts the ability to assess the accountability for all assets and liabilities of the entity, as well as the entity's system of internal control.

How Events or Conditions are Subject To, or Affected By, the Inherent Risk Factors

- A83. The auditor is required to consider events or conditions in understanding how the applicable financial reporting framework applies in the context of the nature and circumstances of the entity. In doing so, the auditor identifies how events or conditions are subject to, or affected by, the inherent risk factors, which may assist the auditor in understanding which classes of transactions, account balances and disclosures may be affected. Understanding whether, and the relative degree to which the inherent risk factors affect the events and conditions may assist the auditor in identifying and assessing the risks of material misstatement at the assertion level. Appendix 2 provides examples of events and conditions that may indicate susceptibility to risks of material misstatement, categorised by inherent risk factor.
- A84. The extent to which a class of transactions, account balance or disclosure is subject to, or affected by, complexity or subjectivity, is often closely related to the extent to which it is subject to change or uncertainty. Further, when a class of transactions, account balance or disclosure is subject to, or affected by, complexity, subjectivity, change or uncertainty, these inherent risk factors may create opportunity for management bias, whether unintentional or intentional, and affect susceptibility to misstatement due to management bias or fraud. Accordingly, the auditor's identification of risks of material misstatement, and assessment of inherent risk at the assertion level, are also affected by the interrelationships among the inherent risk factors.
- A85. Events or conditions that may be affected by, or subject to, the susceptibility of misstatement due to management bias or fraud may be indicative of increased risks of material misstatement due to fraud. Accordingly, this may be relevant information for use in accordance with paragraph 24 of ASA 240, which requires the auditor to evaluate whether the information obtained from the other risk assessment procedures and related activities indicates that one or more fraud risk factors are present.
- A86. When complexity is an inherent risk factor, there may be an inherent need for more complex processes in preparing the information, and such processes may be inherently more difficult to apply. As a result, applying them may require specialised skills or knowledge, and may require the use of a management's expert. For example, when there are many potential data sources, with different characteristics, and the processing of that data involves many interrelated steps, the data may be inherently more difficult to identify, capture, access, understand or process.

- A87. When management judgement is more subjective, the susceptibility to misstatement due to management bias, whether unintentional or intentional, may also increase. For example, significant management judgement may be involved in making accounting estimates that have been identified as having high estimation uncertainty, and conclusions regarding methods, models and assumptions may reflect unintentional or intentional management bias.
- A88. Where there are increased opportunities for intentional management bias or fraud (e.g., owner-managed entities where there is an increased opportunity for management override of controls), the auditor may identify an increased susceptibility to misstatement due to management bias or fraud.

Obtaining an Understanding of the Entity's System of Internal Control (Ref: Para. 25-26)

- A89. Obtaining an understanding of the components of the entity's system of internal control:
- Assists the auditor in identifying and assessing the risks of material misstatement at the financial statement level and the assertion level; and
 - Provides a basis for the auditor's determination of the extent to which the auditor plans to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures in accordance with ASA 330.
- A90. The auditor is required to perform risk assessment procedures to obtain an understanding of each component of internal control relevant to financial reporting. Paragraphs 27–38 address the matters the auditor is required to understand in relation to the components of the system of internal control. The nature, timing, and extent of risk assessment procedures that the auditor performs to obtain this understanding are matters of the auditor's professional judgement and are based on the auditor's determination as to what will provide sufficient and appropriate audit evidence for the auditor's identification and assessment of risks of material misstatement. Accordingly, the nature, timing and extent of procedures to understand the entity's system of internal control will vary from entity to entity, and may depend on matters such as:
- The size and complexity of the entity, including its IT environment.
 - Previous experience with the entity.
 - The nature of each component⁴¹ of the entity's system of internal control.
 - The nature and form of the entity's documentation, including as it relates to specific controls.
- A91. The entity's use of IT and the nature and extent of changes in the IT environment may also affect the specialised skills that are needed to assist with obtaining the required understanding.
- A92. Appendix 3 further describes the nature of the entity's system of internal control and inherent limitations of internal control, respectively. Appendix 3 also provides further explanation of the components of a system of internal control for the purposes of the Australian Auditing Standards.

System of Internal Control Relevant to Financial Reporting

- A93. The entity's system of internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

⁴¹ See paragraph 102.

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

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

- A94. The entity's system of internal control relevant to financial reporting will include aspects of the system of internal control that relate to the entity's reporting objectives, including its financial reporting objectives, but may also include aspects that relate to its operations or compliance objectives, when such aspects are relevant to financial reporting. For example, controls over compliance with laws and regulations may be relevant to financial reporting when such controls are relevant to the entity's preparation of contingency disclosures in the financial report. In particular, the auditor is required by paragraph 35 to understand how the entity initiates transactions and captures information relevant to financial reporting as part of the auditor's understanding of the information system. Such information may include information from the entity's systems and controls designed to address compliance and operations objectives. Further, some entities may have information systems that are highly integrated such that controls may be designed in a manner to simultaneously achieve financial reporting, compliance and operational objectives, and combinations thereof.
- A95. For the purposes of this ASA, the system of internal control relevant to financial reporting means the system of internal control relevant to the preparation of the financial report in accordance with the requirements of the applicable financial reporting framework.

Considerations Specific to Public Sector Entities

- A96. Auditors of public sector entities often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice or reporting on spending against budget. Auditors of public sector entities may also have responsibilities to report on compliance with law, regulation or other authority. As a result, their considerations about the system of internal control may be broader and more detailed.

Understanding the Entity's Use of Information Technology in the Components of the System of Internal Control

- A97. An entity's system of internal control contains manual elements and automated elements. An entity's mix of manual and automated elements in the entity's system of internal control varies with the nature and complexity of the entity's use of IT. The overall objective and scope of an audit does not differ whether an entity operates in a mainly manual environment, a completely automated environment, or an environment involving some combination of manual and automated elements. An entity's use of IT affects the manner in which the information relevant to financial reporting is processed, stored and communicated, and therefore affects the manner in which the system of internal control relevant to financial reporting is designed and implemented. Each component of the system of internal control may involve some extent of automation. The auditor's understanding of the system of internal control relevant to financial reporting involves understanding the entity's use of IT for each component.
- A98. The characteristics of manual or automated elements are relevant to the auditor's identification and assessment of the risks of material misstatement, and further audit procedures based thereon. Automated controls may be more reliable than manual controls because they cannot be as easily bypassed, ignored, or overridden, and they are also less prone to simple errors and mistakes. Automated controls may be more effective than manual controls in the following circumstances:

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

Components of the Entity's System of Internal Control

- A99. The components of the entity's system of internal control for the purpose of this ASA do not necessarily reflect how an entity designs, implements and maintains its system of internal control, or how it may classify any particular component. Entities may use different terminology or frameworks to describe the various aspects of the system of internal control. For the purpose of an audit, auditors may also use different terminology or frameworks provided all the components described in this ASA are addressed.
- A100. The entity's system of internal control relevant to financial reporting addresses the prevention, detection and correction of misstatements in the entity's financial report; however, the manner in which the individual components operate in this respect differs. The control environment provides the overall foundation for the operation of the other components of the system of internal control. Similarly, the entity's risk assessment process and its process for monitoring the system of internal control are designed to operate in a manner that also supports the entire system of internal control. Therefore these components support the controls within the other components of the entity's system of internal control. Due to the manner in which the controls within these components are designed to operate, they are typically not precise enough to prevent, or detect and correct, misstatements at the assertion level and instead may have an indirect effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls may be referred to as "indirect controls."
- A101. In contrast, the information system and communication component, as well as the control activities component, typically include controls that are designed to prevent, or to detect and correct, misstatements at the assertion level for the classes of transactions, account balances and disclosures in the entity's financial report. Such controls may be referred to as "direct controls."
- A102. The nature of each of the components of the entity's system of internal control may also affect the auditor's identification and assessment of the risks of material misstatement as follows:
- The auditor's understanding of the entity's control environment, risk assessment process, and the entity's process to monitor controls are more likely to affect the identification and assessment of risks of material misstatement at the financial statement level.
 - The auditor's understanding of the information system and communication component, and the control activities component, are more likely to affect the identification and assessment of risks of material misstatement at the assertion level.
- A103. Notwithstanding the types of controls that are typically within each component of the entity's system of internal control, direct or indirect controls may exist in any of the components. In particular, the control activities component includes general IT controls, which may include 'indirect controls.' For example, controls that address the continued functioning of automated controls over the processing of transactions, such as controls over the integrity of information in the entity's information system, may also include 'direct controls.'

Controls Relevant to the Audit (Ref: Para. 26)

- A104. The auditor identifies controls relevant to the audit in accordance with paragraphs 39 through 41. Controls relevant to the audit are likely to include mainly controls that address potential risks of misstatement at the assertion level (i.e., controls in the control activities component).

However, controls relevant to the audit may also include controls in other components of the system of internal control, i.e., the control environment, the risk assessment process and the process to monitor controls components that address the risks of material misstatement at the assertion level. The auditor evaluates the design of each control relevant to the audit and determines whether it has been implemented in accordance with paragraph 42.

Understanding the Components of the Entity's System of Internal Control (Ref: Para. 27-38)

Control Environment (Ref: Para. 27)

- A105. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's system of internal control and its importance in the entity. The control environment sets the tone of an organisation, influencing the control consciousness of its people.
- A106. The control environment relating to smaller and less complex entities is likely to vary from larger or more complex entities. For example, the organisational structure may be simpler and include a small number of employees involved in roles related to financial reporting. Further, those charged with governance in smaller and less complex entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. Accordingly, some considerations about the entity's control environment may be inapplicable or less relevant. For example, if the role of governance is undertaken directly by the owner-manager, the auditor may determine that the independence of those charged with governance is not relevant.
- A107. In addition, audit evidence for elements of the control environment in smaller and less complex entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, but is still effective. For example, such entities may not have a written code of conduct but, instead, develop a culture that emphasises the importance of integrity and ethical behaviour through oral communication and by management example. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller and less complex entity's control environment.

Understanding the Control Environment

- A108. Audit evidence for the auditor's understanding of the control environment may be obtained through a combination of enquiries and other risk assessment procedures (i.e., corroborating enquiries through observation or inspection of documents). The nature, timing and extent of the auditor's procedures to obtain the understanding of the control environment may vary to the extent necessary, to provide an appropriate basis for the required evaluation in paragraph 28. For example, in considering the extent to which management demonstrates a commitment to integrity and ethical values, the auditor may obtain an understanding through enquiries of management and employees about how management communicates to employees its views on business practices and ethical behaviour and inspecting management's written code of conduct and observing whether management acts in a manner that supports that code.
- A109. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified control deficiencies relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.
- A110. The auditor's consideration of the entity's use of IT as it relates to the control environment may include such matters as:
- Whether governance over IT is commensurate with the nature and size of the entity and its business operations enabled by IT, including the complexity or maturity of the entity's technology platform or architecture and the extent to which the entity relies on IT applications to support its financial reporting.

- The management organisational structure regarding IT and the resources allocated (for example, whether the entity has invested in an appropriate IT environment and necessary enhancements, or whether a sufficient number of appropriately skilled individuals have been employed including when the entity uses commercial software (with no or limited modifications)).

Evaluating the Control Environment (Ref: Para. 28)

- A111. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific controls in the control activities component) and thereby, the auditor's identification and assessment of the risks of material misstatement. As further explained in paragraph A218–A219, control deficiencies in the control environment may lead to risks of material misstatement at the financial statement level, which may have implications for the audit, including, as explained in ASA 330, an influence on the nature, timing and extent of the auditor's further procedures.⁴²
- A112. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. An entity's control consciousness is influenced by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:
- Their independence from management and their ability to evaluate the actions of management.
 - Whether they understand the entity's business transactions.
 - The extent to which they evaluate whether the financial report is prepared in accordance with the applicable financial reporting framework, including whether the financial report includes adequate disclosures.
- A113. Some entities may be dominated by a single individual who may exercise a great deal of discretion. The actions and attitudes of that individual may have a pervasive effect on the culture of the entity, which in turn may have a pervasive effect on the control environment. Such an effect may be positive or negative. For example, direct involvement by this single individual may be key to enabling the entity to meet its growth and other objectives, and can also contribute significantly to an effective system of internal control. On the other hand, such concentration of knowledge and authority can also lead to an increased susceptibility to misstatement through management override of controls.
- A114. Active involvement by those charged with governance, who are also independent, may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings. Overall, although a control environment that provides an appropriate foundation for the system of internal control may help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent to fraud.

⁴² See ASA 330, paragraphs A2-A3.

The Entity's Risk Assessment Process (Ref: Para. 29-31)

- A115. The entity's risk assessment process is an iterative process for identifying and analysing risks to achieving the entity's objectives, and forms the basis for how management or those charged with governance determine the risks to be managed.
- A116. The extent to which an entity's risk assessment process is formalised may vary. Some entities, including smaller and less complex entities, and particularly owner-managed entities, may not have established a structured risk assessment process, or the risk assessment process may not be documented or performed on regular basis. Irrespective whether the risk assessment process is formally established or not, the auditor may still obtain the understanding required by paragraph 29 about how the entity identifies risks relevant to financial reporting and how these risks are addressed through observation and enquiry.

Understanding the Entity's Risk Assessment Process (Ref: Para. 29)

- A117. In order to understand how management and those charged with governance have identified business risks relevant to financial reporting objectives, and have decided about actions to address those risks, matters the auditor may consider include how management or, as appropriate, those charged with governance have:
- Specified objectives with sufficient clarity to enable the identification and assessment of the risks relating to the objectives;
 - Identified the risks to achieving the entity's objectives and analysed the risks as a basis for determining how the risks should be managed;
 - Considered the potential for fraud when considering the risks to achieving the entity's objectives; and
 - Identified and evaluated changes that could significantly affect the entity's system of internal control.

As explained in paragraph A59, not all business risks give rise to risks of material misstatement.

- A118. The nature, timing and extent of the auditor's risk assessment procedures to obtain the understanding of the entity's risk assessment process may vary to the extent necessary, to provide an appropriate basis for the required evaluation in paragraph 31.
- A119. Understanding the risks arising from the entity's use of IT identified by the entity, as well as how these risks have been addressed, is an important input to the auditor's identification of risks arising from the use of IT in accordance with paragraph 41. It may also help the auditor understand the nature and extent of automated processes, and the data, used in controls that may be relevant to the audit.

Evaluating the Appropriateness of the Entity's Risk Assessment Process (Ref: Para. 31)

- A120. Whether the entity's risk assessment process is appropriate to the circumstances of the entity, including its nature, size, and complexity, is a matter of the auditor's professional judgement. For example, in some smaller and less complex entities, and particularly owner-managed entities, an appropriate risk assessment may be performed through the direct involvement of management or the owner-manager (e.g., the manager or owner-manager may routinely devote time to monitoring the activities of competitors and other developments in the market place to identify emerging risks that may affect how the entity applies the requirements of the applicable financial reporting framework related to the entity's ability to continue as a going concern).

A121. When the auditor determines, in accordance with paragraph 31(b), that a control deficiency exists related to the entity's risk assessment process, the auditor is required to determine, in accordance with paragraph 43, whether any such deficiency constitutes a significant control deficiency. Whether the absence of an appropriate risk assessment process represents a significant control deficiency is a matter of the auditor's professional judgement. Circumstances that may indicate a significant control deficiency exists include matters such as:

- The absence of a risk assessment process when such a process would ordinarily be expected to have been established; or
- Evidence of an ineffective risk assessment process, which may be the case when the process has failed to identify a risk of material misstatement when it would be expected the risk assessment process would have identified the risk.

The Entity's Process to Monitor the System of Internal Control (Ref: Para. 32-34)

A122. The entity's process to monitor the system of internal control is a continuous process to evaluate the effectiveness of the system of internal control and to take necessary remedial actions on a timely basis. The entity's process to monitor the system of internal controls may consist of ongoing activities, separate evaluations (conducted periodically), or some combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. The entity's process will likely vary in scope and frequency depending on the assessment of the risks by the entity.

A123. In smaller and less complex entities, and in particular owner-manager entities, the entity's process to monitor the system of internal control is often accomplished by management's or the owner-manager's direct involvement in operations, and there may not be any other monitoring activities. For example, this is the case when significant variances from expectations and inaccuracies in financial data are identified through the owner-manager's direct involvement. The owner-manager's actions and follow-up may also be how remedial actions are implemented. In such cases, the auditor's understanding of the process to monitor the system of internal control may be accomplished through enquiry of the owner-manager and employees about these activities, and may also involve inspection or observation of related communications or other evidence of remedial actions.

A124. For entities where there is no distinct process for monitoring the system of internal control, it may be difficult to distinguish between controls in the control activities component and activities related to monitoring. For example, a supervisory review may not be considered a monitoring activity by the entity, but the review may have a role in monitoring the effectiveness of underlying controls. For such entities, understanding the process to monitor the system of internal control may include understanding periodic reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A125. Controls in the entity's process to monitor the system of internal control are likely to consist of primarily indirect controls. However, monitoring activities, such as management or supervisory reviews, may be precise enough to address risks of material misstatement at the assertion level (i.e., direct controls). Such controls may also include certain activities performed by the internal audit function. The auditor may determine certain direct controls to be controls relevant to the audit in accordance with paragraph 39–41.

Understanding the Entity's Process to Monitor the System of Internal Control (Ref: Para. 32)

A126. In order to understand how the entity monitors its system of internal control, matters that may be relevant for the auditor to consider include:

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

A127. The entity's process to monitor the system of internal control includes monitoring underlying controls that involve the use of IT, and may include, for example:

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

A128. Controls within the entity's process to monitor the system of internal control, including those that monitor underlying automated controls, may be automated or manual, or a combination of both. For example, an entity may use automated monitoring controls over access to certain technology with automated reports of unusual activity to management, who manually investigate identified anomalies.

Sources of Information (Ref: Para. 33)

A129. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that information used for monitoring is accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

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

is required to provide a basis for the auditor's understanding of the entity's process to monitor the system of internal control.

A130. Management's monitoring activities may use information in communications from external parties such as customer complaints or regulator comments that may indicate problems or highlight areas in need of improvement.

The Entity's Internal Audit Function (Ref: Para. 34)

A131. If the entity has an internal audit function, the auditor's understanding of the entity's process to monitor the system of internal control involves obtaining an understanding of the role that the internal audit function plays in that process. The auditor's enquiries of appropriate individuals within the internal audit function in accordance with paragraph 18(a) of this ASA

help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function. This understanding, together with the information obtained from the auditor's enquiries in paragraph 18(a) of this ASA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

- A132. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.
- A133. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, ASA 610 applies.
- A134. As is further discussed in ASA 610, the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.
- A135. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. ASA 200⁴³ discusses the importance of the auditor planning and performing the audit with professional scepticism, including being alert to information that brings into question the reliability of documents and responses to enquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

The Information System and Communication

The Information System Relevant to Financial Reporting (Ref: Para. 35)

- A136. The information system relevant to financial reporting consists of the policies or procedures, and records, designed and established to:
- Initiate, record, process, and report entity transactions (as well as to capture, process and disclose information about events and conditions other than transactions) 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;

⁴³ See ASA 200, paragraph 15.

- Process and account for system overrides or bypasses to controls;
- Incorporate information from transaction processing in the general ledger (e.g., transferring of accumulated transactions from a subsidiary ledger);
- Capture and process information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortisation of assets and changes in the recoverability of assets; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarised and appropriately reported in the financial report.

A137. An entity's business processes include the activities designed to:

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

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor in obtaining an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

A138. The entity's information system relevant to financial reporting may include the use of manual and automated elements, which also affect the manner in which transactions are initiated, recorded, processed, and reported. In particular, procedures to initiate, record, process, and report transactions may be enforced through the IT applications used by the entity, and how the entity has configured those applications. In addition, records in the form of digital information may replace or supplement records in the form of paper documents.

A139. The information system, and related business processes relevant to financial reporting in smaller and less complex entities is likely to be less sophisticated than in larger entities and involve a less complex IT environment, but the role of the information system is just as important. Regardless of the size or nature of the entity, the information system includes relevant aspects of that system relating to information disclosed in the financial report that is obtained from within or outside of the general and subsidiary ledgers. Smaller and less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's information system relevant to financial reporting may therefore require less effort in an audit of smaller and less complex entity, and may be more dependent on enquiry than on review of documentation. The need to obtain an understanding, however, remains important to identify risks of material misstatement.

A140. The auditor's understanding of the information system relevant to financial reporting required by paragraph 35 includes understanding the flows of information relating to the entity's significant classes of transactions, account balances, and disclosures in the financial report. The auditor's understanding of the information system relevant to financial reporting is not required to include an understanding of the flows of information related to classes of transactions, account balances or disclosures that are not significant classes of transactions, account balances or disclosures.

A141. Risk identification and assessment is an iterative process. The auditor's expectations formed in paragraph 23 about the classes of transactions, account balances and disclosures may assist the auditor in determining the significant classes of transactions, account balances and disclosures in accordance with paragraph 46, which are those that need to be understood when

obtaining an understanding of the information system in accordance with paragraph 35. For example, the auditor may have an expectation that certain significant classes of transactions related to revenue exist, but in obtaining the understanding about the flows of information in the information system, the auditor may identify additional classes of transactions related to revenue that may be significant.

Information Obtained from Outside of the General and Subsidiary Ledgers

A142. Financial report may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information may include:

- Information obtained from lease agreements disclosed in the financial report, such as renewal options or future lease payments.
- Information disclosed in the financial report that is produced by an entity's risk management system.
- Fair value information produced by management's experts and disclosed in the financial report.
- Information disclosed in the financial report that has been obtained from models, or from other calculations used to develop accounting estimates recognised or disclosed in the financial report, including information relating to the underlying data and assumptions used in those models, such as:
 - Assumptions developed internally that may affect an asset's useful life; or
 - Data such as interest rates that are affected by factors outside the control of the entity.
- Information disclosed in the financial report about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.
- Information recognised or disclosed in the financial report that has been obtained from an entity's tax returns and records.
- Information disclosed in the financial report that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.⁴⁴

A143. Certain amounts or disclosures in the entity's financial report (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgement in determining the necessary understanding.

Understanding the Entity's Use of Information Technology in the Information System (Ref: Para. 35(d))

A144. The auditor is required to understand the IT environment relevant to the entity's information system because the entity's use of IT applications or other aspects in the IT environment may give rise to risks arising from the use of IT. The nature and significance of these risks vary based on whether, and the extent to which, the entity relies on IT, including automated controls, to support the processes in its information system and to maintain the completeness

⁴⁴ See ASA 570 *Going Concern*, paragraphs 19-20.

and accuracy of the underlying data and information. The entity may implement general IT controls in response to these risks. General IT controls may be relevant to the audit and may need to be taken into account in the auditor's assessment of control risk at the assertion level.

A145. Examples of risks arising from the use of IT include:

- Inappropriate reliance on IT applications that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.
- Unauthorised changes to IT applications or other aspects of the IT environment.
- Failure to make necessary changes to IT applications or other aspects of the IT environment.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

A146. The auditor may take an approach to obtaining the understanding the IT environment that involves identifying the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances and disclosures flows through the entity's information system.

A147. In obtaining the understanding of the IT environment, the auditor may also obtain a high-level understanding of the IT processes and the personnel involved in maintaining the IT environment (e.g., the number and skill level of the IT support resources that manage security and changes to the environment), which assists the auditor in understanding the complexity of the IT environment. This understanding may include identifying significant changes in the IT environment, which may be revealed through significant changes in the flows of transactions or information through the entity's information system.

A148. Obtaining the auditor's understanding of the IT environment in accordance with paragraph 35(d), and the auditor's identification of IT applications and other aspects of the IT environment relevant to the audit in accordance with paragraph 40, may involve an iterative process or may be performed concurrently. Matters that may be relevant to the auditor's understanding of the IT environment, or the determination of the aspects that are relevant to the audit, include matters such as:

- The extent of automated procedures for processing, and the complexity of those procedures, including, whether there is highly automated, paperless processing.
- The extent of the entity's reliance on system-generated reports in the processing of information.
- How data is input (i.e., manual input, customer or vendor input, or file load).
- How IT facilitates communication between applications, databases or other aspects of the IT environment, internally and externally, as appropriate, through system interfaces.

- The volume and complexity of data in digital form being processed by the system, including whether accounting records or other information are stored in digital form.
 - Matters related to the individual aspects of the IT environment, for example:
 - The type of application (e.g., a commercial application with little or no customization, or a highly-customised or highly-integrated application that may have been purchased and customised, or developed in-house).
 - The complexity of the nature of the IT applications and the underlying IT infrastructure.
 - The complexity of the security over the IT environment, including vulnerability of the IT applications, databases, and other aspects of the IT environment to cyber security risks, particularly when there are web-based transactions or transactions involving external interfaces.
 - The extent of change within the IT environment (e.g., new aspects of the IT environment or significant changes in the IT applications or the underlying IT infrastructure)
 - Whether there is third-party hosting or outsourcing of IT.
 - Whether the entity is using emerging technologies that affect its financial reporting.
 - Whether there was a major data conversion during the period and, if so, the nature and significance of the changes made, and how the conversion was undertaken.
 - Whether program changes have been made to the manner in which information is processed, and the extent of such changes during the period
- A149. Obtaining an understanding of the entity's IT environment may be more easily accomplished for a smaller and less complex entity that uses commercial software and when the entity does not have access to the source code to make any program changes. Such entities may not have dedicated IT resources but may have a person assigned in an administrator role for the purpose of granting employee access or installing vendor-provided updates to the IT applications. Specific matters that the auditor may consider in understanding the nature of a commercial accounting software package, which may be the single IT application used by a smaller and less complex entity in its information system, may include:
- The extent to which the software is well established and has a reputation for reliability;
 - The extent to which it is possible for the entity to modify the source code of the software; and
 - The nature and extent of modifications that have been made to the software. Many software packages allow for configuration (e.g., setting or amending reporting parameters). These do not usually involve modifications to source code; however, the auditor may consider the extent to which the entity is able to configure the software when considering the completeness and accuracy of information produced by the software that is used as audit evidence.
- A150. Complex IT environments may include highly-customised or highly-integrated IT applications and may therefore require more effort to understand. Financial reporting processes or IT applications may be integrated with other IT applications. Such integration may involve IT applications that are used in the entity's business operations and that provide information to the financial reporting IT applications. In such circumstances, certain IT applications used in

the entity's business operations may be relevant to financial reporting. Complex IT environments also may require dedicated IT departments that have structured IT processes supported by personnel that have software development and IT environment maintenance skills. In other cases, an entity may use third-party service providers to manage certain aspects of, or IT processes within, its IT environment.

Evaluating the Design of the Information System Controls Relevant to Financial Reporting
(Ref: Para. 36)

- A151. The information system relevant to financial reporting comprises the entity's financial reporting processes, and the entity's personnel, IT and other resources, deployed in applying those processes. The objective of those processes is to capture, store and process data from internal and external sources, and to produce the entity's accounting records and the information that the entity needs to include in its financial report. The objective of those processes is also to comply with the requirements and principles in the applicable financial reporting framework, and in other applicable laws or regulations. Paragraphs 10–12 of Appendix 3 sets out further matters for consideration relating to the information system.)
- A152. The design of the information system is established in the policies and procedures that define the nature, timing and extent of the entity's financial reporting processes, and how the entity's personnel, IT and other resources are deployed in applying them. Such controls are referred to in this ASA as information system controls relevant to financial reporting. Such policies and procedures may be formally documented, for example in a financial reporting manual, or may be less formally established through communication by management.
- A153. The auditor's understanding of the information system may be obtained in various ways. The auditor's risk assessment procedures to obtain such understanding may include, for example, a combination of:
- Inspection of policy or process manuals or other documentation of the entity's information system;
 - Enquiries of relevant personnel about the procedures used to initiate, record, process and report transactions or about the entity's financial reporting process; or
 - Observation of the performance of the policies or procedures by entity's personnel.
 - Selecting transactions and tracing them through the applicable process in the information system.
- Enquiry alone, however, is not sufficient for such purposes.
- A154. The audit evidence obtained by these risk assessment procedures is used by the auditor to evaluate the design of the information system controls relevant to the financial reporting and determine whether they have been implemented. In evaluating the design of the entity's information system controls relevant to financial reporting, the auditor considers whether such controls would meet their financial reporting objectives, if implemented as designed and operating effectively.
- A155. The auditor may also use automated techniques by obtaining direct access to, or a digital download from, the databases in the entity's information system that store the accounting records of transactions. By using this information, the auditor may confirm the understanding obtained about how transactions flow through the information system by tracing journal entries, or other digital records related to a particular transaction, or an entire population of transactions, from initiation in the accounting records through to recording in the general ledger. Analysis of complete or large sets of transactions may also result in the identification of variations from the normal, or expected, processing procedures for these transactions, which may result in the identification of additional risks of material misstatement related to non-standard procedures.

- A156. Regardless of the techniques used to evaluate the design of the information system and determine whether it has been implemented, the auditor's understanding of the sources of data, and the IT applications involved in processing that data, may also assist the auditor in understanding the IT environment.
- A157. The entity also establishes controls that are designed to support the operating effectiveness of the controls within the information system. For purposes of the ASAs, controls over the information system are treated as controls in the control activities component and may be identified as controls relevant to the audit. The objectives of such controls may include, for example, maintaining the integrity or security of the data captured, stored or processed, and of the accounting records and information produced by the information system. The auditor is required to evaluate the design of those controls and determine whether they have been implemented, in accordance with paragraph 42. These procedures may be performed together with the procedures performed to evaluate the design of the information system controls relevant to financial reporting. For example, the auditor may perform a walk-through of a transaction to confirm the flow of transactions relevant to the transaction and at the same time, evaluate the design and implementation of controls relevant to the audit that relate to that class of transactions, such as those related to approvals or reconciliations.

Communication (Ref: Para. 37)

- A158. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to the system of internal control relevant to financial reporting. It may include such matters as the extent to which personnel understand how their activities in the information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals, particularly in larger entities.
- A159. Communication may be less structured (e.g., formal manuals may not be used) and easier to achieve in a smaller and less complex entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability. Regardless of the size of the entity, open communication channels help ensure that exceptions are reported and acted on.

Control Activities (Ref: Para. 38)

- A160. Controls in the control activities component include those controls over the flows of information within the information system relating to significant classes of transactions, account balances and disclosures and the financial reporting process used to prepare the financial report. Such controls consist of application controls and general IT controls, both of which could be manual or automated. Regardless of whether controls are within the IT environment or manual systems, controls may have various objectives and may be applied at various organisational and functional levels. Examples of controls in the control activities component include authorisations and approvals, reconciliations, verifications (such as edit and validation checks or automated calculations), segregation of duties, and physical or logical controls, including those addressing safeguarding of assets.
- A161. Controls in smaller and less complex entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, in smaller and less complex entities, more controls may be directly applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions.
- A162. Some individual controls may consist of both automated and manual aspects, such as controls that may use information produced by IT (e.g., an exception report) that is subject to manual procedures (e.g., review and follow-up). For many entities, most controls may be automated controls or involve a combination of automated and manual aspects because of the extent of

use of IT applications for financial reporting purposes. In some cases, authorisations, approvals and the preparation of reconciliations may involve the use of technology enabled workflow or use of supporting records in digital form.

- A163. The greater the extent of automated controls, or controls involving automated aspects, that management uses and relies on in relation to its financial reporting, the more important it may become for the entity to implement general IT controls that address the continued functioning of the automated aspects of application controls.
- A164. It may be less practicable to establish segregation of duties in smaller and less complex entities that have fewer employees. However, in an owner-managed entity, the owner-manager may be able to exercise more effective oversight through direct involvement than in a larger entity, which may compensate for the generally more limited opportunities for segregation of duties. Although, as also explained in ASA 240, domination of management by a single individual can be a potential control deficiency since there is an opportunity for management override of controls.⁴⁵
- A165. Controls in the control activities component may include controls established by management that address risks of material misstatement related to disclosures not being prepared in accordance with the applicable financial reporting framework. Such controls may relate to information included in the financial report that is obtained from outside of the general and subsidiary ledgers.

Controls Relevant to the Audit (Ref: Para. 39-41)

Determining controls relevant to the audit (Ref: Para. 39)

- A166. Controls relevant to the audit are primarily direct controls and are primarily controls in the control activities component because such controls typically are controls over the entity's information system and address risks of material misstatement at the assertion level. However, there may be direct controls that exist in the control environment, the entity's risk assessment process or the entity's process to monitor the system of internal control components. Controls are required to be relevant to the audit when such controls meet one or more of the criteria included in paragraph 39. However, when multiple controls each achieve the same objective, it is unnecessary to identify each of the control related to such objective.
- A167. Controls relevant to the audit are required to include controls over journal entries because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. The extent to which other controls are relevant to the audit may vary based on the nature of the entity and the auditor's planned approach to further audit procedures. For example, in an audit of a smaller and less complex entity, the entity's information system may not be complex and the auditor may not be required to, or plan to, rely on the operating effectiveness of any controls. Further, the auditor may not have identified any significant risks or any other risks of material misstatement for which it is necessary for the auditor to evaluate the design of controls and determine that they have been implemented. In such an audit, the auditor may determine that there are no controls relevant to the audit other than the entity's controls over journal entries.

Controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence (Ref: Para. 39(a))

- A168. The auditor determines whether there are any risks of material misstatement at the assertion level for which it is not possible or practicable to obtain sufficient appropriate audit evidence through substantive procedures alone as described in paragraph 51. The auditor is required, in

⁴⁵ See ASA 240, paragraph A27.

Proposed Auditing Standard ASA 315
Identifying and Assessing the Risks of Material Misstatement

accordance with ASA 330,⁴⁶ to design and perform tests of relevant controls that address such risks of material misstatement when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. As a result, when such controls exist that address these risks, they are relevant to the audit.

Controls that address significant risks (Ref: Para. 39(b))

- A169. The auditor determines whether any assessed risks of material misstatement at the assertion level are significant risks in accordance with paragraph 49. Significant risks are those that exist close to the upper end of the spectrum of inherent risk and therefore are those risks of material misstatement that require the most persuasive audit evidence in accordance with ASA 330.⁴⁷ Paragraph 39 requires that the auditor identify controls that address significant risks to be controls relevant to the audit. The risk assessment procedures performed to understand these controls in accordance with paragraph 42 contribute to the audit evidence related to the significant risk.
- A170. Regardless of whether the auditor intends to test the operating effectiveness of controls that address significant risks, the understanding obtained about management's approach to addressing those risks may inform the design and performance of substantive procedures responsive to significant risks as required by ASA 330.⁴⁸ Although risks relating to significant non-routine or judgemental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgemental matters includes whether and how management responds to the risks. Such responses might include:
- Controls such as a review of assumptions by senior management or experts.
 - Documented processes for accounting estimations.
 - Approval by those charged with governance.
- A171. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial report.
- A172. ASA 240⁴⁹ requires the auditor to identify the controls that address risks of material misstatement due to fraud as controls relevant to the audit and explains that it is important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In identifying the controls relevant to the audit that address the risks of material misstatement due to fraud, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties.
- A173. In some cases, management may not have appropriately responded to significant risks by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant control deficiency.⁵⁰

⁴⁶ See ASA 330, paragraph 8.

⁴⁷ See ASA 330, paragraph 7(b).

⁴⁸ See ASA 330, paragraph 21.

⁴⁹ See ASA 240, paragraphs 27 and A32.

⁵⁰ See ASA 265, paragraph A7.

Controls over journal entries (Ref: Para. 39(c))

- A174. 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 or a subsidiary ledger, or to record accounting estimates that are periodically made by management, such as changes in the accounting estimate of uncollectible accounts receivable.
- A175. 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 consolidation adjustments, 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 report, such entries may exist only in electronic form and may therefore be more easily identified through the use of automated techniques. For example, applying automated techniques to analyse an entire population of journal entries within a general ledger may assist in understanding the nature and extent of journal entries made, which account balances are subject to standard or non-standard journal entries, and which entity personnel made or authorised the journal entries. These techniques can be accompanied by enquiries of management or inspection of supporting documentation for journal entries to identify the controls the entity has implemented over journal entries.

Testing of operating effectiveness of controls (Ref: Para. 39(d))

- A176. When the auditor determines that a risk(s) for which substantive procedures alone cannot provide sufficient appropriate audit evidence exists, the auditor is required to, in accordance with ASA 330,⁵¹ design and perform tests of relevant controls. Further, when the auditor voluntarily intends to take into account the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures, such controls are required to be identified as relevant to the audit because ASA 330⁵² requires the auditor to design and perform tests of those controls. For example, the auditor may plan to test controls over routine classes of transactions because such testing may be more effective or efficient for large volumes of homogenous transactions.
- A177. The auditor's intentions to test the operating effectiveness of controls may also be influenced by the identified risks of material misstatement at the financial statement level. For example, if deficiencies are identified related to the control environment, this may affect the auditor's overall expectations about the operating effectiveness of direct controls.
- A178. The auditor may plan to test the operating effectiveness of controls over the completeness and accuracy of information produced by the entity when the auditor intends to take into account the operating effectiveness of those controls in designing and performing further audit procedures to determine the reliability of that information for its use as audit evidence. The auditor may also plan to test the operating effectiveness of controls relating to operations and compliance objectives when they relate to data the auditor evaluates or uses in applying audit procedures.

Other controls relevant to the audit (Ref: Para. 39(e))

- A179. The extent to which other controls are identified as relevant to the audit is a matter of the auditor's professional judgement. The auditor's judgement about whether it is appropriate to devote additional attention to evaluating the design of controls and determining whether they

⁵¹ See ASA 330, paragraph 8.

⁵² See ASA 330, paragraph 8(a).

have been implemented in order to provide a basis for the design and performance of further audit procedures is influenced by:

- The auditor's knowledge about the presence or absence of controls obtained from the understanding of the components of the system of internal control. For example, when an engagement is new or the entity has made significant changes to its information system, the auditor may determine that more information about the entity's controls is needed to provide a basis for the design of the auditor's further audit procedures, including to assist the auditor in deciding whether to test the operating effectiveness of such controls; and
- The identification of risks of material misstatement and the related assessments of inherent risk at the assertion level because ASA 330 requires more persuasive audit evidence the higher the auditor's assessment of risk.⁵³ For risks that are assessed as higher, but are not significant risks, the auditor may identify controls over those risks to be relevant to the audit. Similar to controls over significant risks, the auditor's evaluation of the design of these controls and determination of whether they have been implemented contributes to the audit evidence related to the higher risk. This understanding of controls may also assist the auditor in designing further audit procedures responsive to the risk.

IT Applications and Other Aspects of the IT Environment Relevant to the Audit (Ref: Para 35(d) and 40)

- A180. An entity may be using and relying upon IT to accurately process and maintain the integrity of information in the entity's information system relevant to financial reporting. In obtaining the understanding of the IT environment in accordance with paragraph 35(d), the auditor may have obtained information about the nature and number of the IT applications and the complexity of the IT processes in the entity's IT environment. Obtaining a high-level understanding of the extent to which the entity's IT processes include the implementation of general IT controls may assist the auditor in identifying whether there are IT applications on which management is relying for the purposes of financial reporting and that therefore may be IT applications relevant to the audit. In addition, the auditor is required to take into account the matters included in paragraph 39 because these matters may further assist the auditor in identifying those IT applications for which the entity's general IT controls may be relevant to the audit.
- A181. In smaller and less complex entities that use commercial software and that do not have access to the source code to make any program changes, the entity may not have any IT processes other than, for example, to process updates to the software received from the vendor. Also, in smaller and less complex entities, management may not be relying on the IT applications, and the controls within them, to maintain the integrity of information. For example, management may instead be relying on reconciliations of information about transactions processed by the IT application to hard copy records or external documents (e.g., reconciliation of cash sales to deposits reported on a bank statement). When an entity uses an IT application that is reputable, widely-used and considered reliable, is unable to change its programming, and maintains hard-copy accounting records, the auditor may determine that there are no IT applications relevant to the audit. In such a case, the auditor is also likely to be able to obtain audit evidence about the completeness and accuracy of the information produced by the entity used as audit evidence through substantive testing without the need to test controls over its production.
- A182. In larger entities, the entity may be relying on IT to a greater extent and the IT environment may involve multiple IT applications and the IT processes to manage the IT environment may be complex. When an entity has greater complexity in its IT environment, determining the IT

⁵³ See ASA 330, paragraph 7(b).

applications and other aspects of the IT environment that are relevant to the audit is likely to require the involvement of team members with specialised skills in IT.

Matters taken into account in identifying IT applications relevant to the audit

- A183. Automated controls that may be determined to be relevant to the audit in accordance with paragraph 40 may include, for example, automated calculations or input, processing and output controls, such as a three-way match of a purchase order, shipping document, and vendor invoice. System-generated reports that the auditor may intend to use as audit evidence may include, for example, a trade receivable aging report or an inventory valuation report.
- A184. In considering whether the IT applications in which automated controls exist and reports are generated are relevant to the audit, the auditor is likely to consider whether, and the extent to which, the entity may have access to source code that enables management to make program changes to such controls or the IT applications. For system-generated reports to be used as audit evidence, the auditor may obtain audit evidence about the completeness and accuracy of the reports by substantively testing the inputs and outputs of the report. In other cases, the auditor may plan to test the operating effectiveness of the controls over the preparation and maintenance of the report, in which case the IT application from which it is produced is likely to be relevant to the audit.
- A185. Some IT applications may include report-writing functionality within them while some entities may also utilize separate report-writing applications (i.e., report-writers). In such cases, the auditor may need to determine the sources of system-generated reports (i.e., the application that prepares the report and the data sources used by the report) to determine the IT applications relevant to the audit. The data sources used by IT applications may be databases that, for example, can only be accessed through the IT application or by IT personnel with database administration privileges. In other cases, the data source may be a data warehouse that may itself be considered to be an IT application relevant to the audit.
- A186. The entity's ability to maintain the integrity of information stored and processed in the information system may vary based on the complexity and volume of the related transactions and other information. The greater the complexity and volume of data that supports a significant class of transactions, account balance or disclosure, the less likely it may become for the entity to maintain integrity of that information through application controls alone (e.g., input and output controls or review controls). It also becomes less likely that the auditor will be able to obtain audit evidence about the completeness and accuracy of such information through substantive testing alone when such information is used as audit evidence. In some circumstances, when volume and complexity of transactions are lower, management may have an application control that is sufficient to verify the accuracy and completeness of the data (e.g., individual sales orders processed and billed may be reconciled to the hard copy originally entered into the IT application). When the entity relies on general IT controls to maintain the integrity of certain information used by IT applications, the auditor may determine that the IT applications that maintain that information are relevant to the audit.
- A187. The auditor may have identified a risk for which substantive procedures alone are not sufficient because of the entity's use of highly-automated and paperless processing of transactions, which may involve multiple integrated IT applications. In such circumstances, the controls relevant to the audit are likely to include automated controls. Further, the entity may be relying on general IT controls to maintain the integrity of the transactions processed and other information used in processing. In such cases, the IT applications involved in the processing and the storage of the information are likely relevant to the audit.

Identifying other aspects of the IT environment that are relevant to the audit

- A188. The other aspects of the IT environment that may be relevant to the audit include the network, operating system and databases, and in certain circumstances interfaces between IT applications. When there are no IT applications relevant to the audit, other aspects of the IT environment are also not relevant. When there are IT applications relevant to the audit, the

other aspects of the IT environment that are relevant to the audit varies based on the extent to which such aspects support and interact with the IT applications determined to be relevant to the audit. The database(s) that stores the data processed by an IT application relevant to the audit is also relevant to the audit. Similarly, because an IT application's ability to operate is often dependent on the operating system, the operating system is typically relevant to the audit. The network may be relevant to the audit, for example, when an IT application interacts with vendors or external parties through the internet.

Risks Arising from the Use of IT and General IT Controls Relevant to the Audit (Ref: Para. 41)

- A189. The extent and nature of the risks arising from the use of IT vary depending on the nature and characteristics of the IT applications and other aspects of the IT environment relevant to the audit. Specific IT risks may result when the entity uses third-party hosting for relevant aspects of its IT environment. It is more likely that there will be more IT risks arising from the use of IT when the volume or complexity of automated application controls is higher and management is placing greater reliance on those controls for effective processing of transactions or the effective maintenance of the integrity of underlying information. Examples of risks arising from the use of IT are included in paragraph A145.
- A190. General IT controls are implemented to address risks arising from the use of IT. Accordingly, the auditor uses the understanding obtained about the IT applications and other aspects of the IT environment that are relevant to the audit and the related risks arising from the use of IT in determining the general IT controls relevant to the audit. In doing so, the auditor may take an approach of understanding the general IT controls that the entity has established over its IT processes for management of access, program change and IT operations for each IT application or other aspect of the IT environment that is relevant to the audit. In some cases, an entity may use common IT processes across its IT environment or across certain IT applications, in which case common risks arising from the use of IT and common general IT controls may be identified.
- A191. In identifying the risks arising from the use of IT, the auditor may also consider the nature of the IT application or other aspect of the IT environment and the reasons for it being determined to be relevant to the audit. For some IT applications or other aspects of the IT environment, the risks identified may relate primarily to unauthorised access or unauthorised program changes. In the case of databases or data warehouses, the auditor may be focused on the risk of inappropriate changes to the data through direct database access and the ability to directly manipulate information.
- A192. In general, a greater number of general IT controls related to IT applications and databases are likely to be relevant to the audit than for other aspects of the IT environment. This is because these aspects are the most closely concerned with the processing and storage of information and most subject to automated controls used in the entity's information system. In identifying general IT controls, the auditor may consider controls over actions of both end users and of the entity's IT personnel or IT service providers.
- A193. Identifying the risks arising from the use of IT and the general IT controls relevant to the audit is likely to require the involvement of team members with specialised skills in IT, other than for the simplest of IT environments. Such involvement is likely to be essential, and may need to be extensive, for complex IT environments. Appendix 4 provides further explanation of the nature of the general IT controls typically implemented for different aspects of the IT environment. In addition, examples of general IT controls for different IT processes are provided.

Evaluating the Design, and Determining Implementation of, Controls Relevant to the Audit
(Ref: Para 42)

- A194. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements (i.e., the control objective). Implementation of a control

means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not designed effectively, and so the design of a control is considered first. An improperly designed control may represent a significant control deficiency.

- A195. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to risks of material misstatement in the context of processes and, when applicable, IT applications in which they exist. The relationship to IT applications assists with relating the general IT controls relevant to the audit to the controls that they support. In many cases, an individual control may not in itself adequately address a risk of material misstatement. Often, only multiple controls, together with other components of the system of internal control, will be sufficient to address a risk of material misstatement.
- A196. Conversely, some controls may have a specific effect on an individual risk of material misstatement at the assertion level embodied in a particular significant class of transactions or account balance. For example, the controls that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the risks of material misstatement relevant to the existence and completeness assertions for the inventory account balance.
- A197. Controls that support other controls are indirect controls. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements related to the risk of material misstatement. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the risks of material misstatement relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing those risks than controls more directly related thereto, such as matching shipping documents with billing documents. Similarly, a general IT control alone is typically not sufficient to address a risk of material misstatement at the assertion level.
- A198. Risk assessment procedures to obtain audit evidence about the design and implementation of controls relevant to the audit may include:
- Enquiring of entity personnel.
 - Observing the application of specific controls.
 - Inspecting documents and reports.
- Enquiry alone, however, is not sufficient for such purposes.
- A199. Evaluating the design and determining the implementation of controls relevant to the audit is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, the auditor may evaluate the design and determine whether the control has been implemented concurrently with the testing of its operating effectiveness, when, for example, there is some automation that provides for consistent operation of the control and the relevant risks arising from the use of IT have been addressed (e.g., when general IT controls are operating effectively). Tests of the operating effectiveness of controls, including tests of indirect controls, are further described in ASA 330.⁵⁴

⁵⁴ See ASA 330, paragraphs 8-11.

A200. Notwithstanding that the risk assessment procedures to obtain audit evidence about the design and implementation of controls relevant to the audit are not sufficient to test the operating effectiveness of controls (and thus assess control risk below the maximum), these procedures provide information important to the auditor's identification and assessment of the risks of material misstatement, and to the design of further audit procedures. In addition to contributing toward the auditor's understanding of the components of the entity's system of internal control, the results of these risk assessment procedures may:

- Influence the auditor's plans to test the operating effectiveness of the controls. When a control is not designed or implemented effectively, there is no benefit in testing it. Conversely, the auditor may conclude that a control, which is effectively designed and implemented, may be appropriate to test in order to take its operating effectiveness into account in designing substantive procedures. When the auditor plans to test a control, the information obtained about the extent to which the control addresses the risk(s) of material misstatement is an input to the auditor's control risk assessment at the assertion level.
- Provide the auditor with a greater understanding of the risks of material misstatement, including the identification of additional risks of material misstatement. This understanding is used in designing the nature, timing and extent of substantive audit procedures that are responsive to the risks of material misstatement, including when the auditor does not plan to test the operating effectiveness of the controls. For example, the results of these procedures may inform the auditor's consideration of possible deviations in a population when designing audit samples.
- Result in the identification of risks of material misstatement at the financial statement level when the results of the auditor's procedures are inconsistent with expectations about the entity's system of internal control that may have been set based on information obtained during the engagement acceptance or continuance process.

Identifying and Assessing the Risks of Material Misstatement

A201. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls relevant to the audit and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed in accordance with ASA 330. In identifying and assessing the risks of material misstatement in the financial report, the auditor exercises professional scepticism in accordance with ASA 200.⁵⁵

A202. The auditor's understanding required by paragraphs 23 to 25, and the identification and assessment of the risks of material misstatement, is an iterative process. For example, the auditor may form initial expectations about the significant classes of transactions, account balances and disclosures based on the understanding of the entity and its environment and the applicable financial reporting framework obtained in accordance with paragraph 23. These expectations may be confirmed or updated as the auditor performs further risk assessment procedures to address the requirements in paragraphs 24 and 25, in particular relating to the auditor's understanding of the entity's information system. Specifically, the auditor may identify additional risks of material misstatement related to the classes of transactions, account balances or disclosures that were expected to be significant, thus confirming their significance. The auditor may also identify risks of material misstatement at the assertion level that are related to classes of transactions, account balances or disclosures not previously considered significant and which may therefore give rise to the identification of additional significant classes of transactions, account balances, or disclosures. (Ref: Para. 45(b) and 46)

⁵⁵ See ASA 200, paragraph 15.

The Use of Assertions

- A203. In identifying and assessing the risks of material misstatement, the auditor may use the assertions as described in paragraph A204(a)–(b) below or may express them differently provided all aspects described below have been covered. For example, the auditor may choose to combine the assertions about classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.
- A204. Assertions used by the auditor in considering the different types of potential misstatements that may occur may fall into the following categories:
- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:
 - (i) Occurrence—transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial report have been included.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
 - (iv) Cut-off—transactions and events have been recorded in the correct accounting period.
 - (v) Classification—transactions and events have been recorded in the proper accounts.
 - (vi) Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
 - (b) Assertions about account balances, and related disclosures, at the period end:
 - (i) Existence—assets, liabilities, and equity interests exist.
 - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial report have been included.
 - (iv) Accuracy, valuation and allocation—assets, liabilities, and equity interests have been included in the financial report at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
 - (v) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.
 - (vi) Presentation—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are

relevant and understandable in the context of the requirements of the applicable financial reporting framework.

- A205. The assertions described in paragraph A204(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. As an example of such a disclosure, the entity may be required to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

Considerations Specific to Public Sector Entities

- A206. When making assertions about the financial report of public sector entities, in addition to those assertions set out in paragraph A204(a)–(b), management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.

Identifying Risks of Material Misstatement (Ref: Para. 45)

- A207. The required understanding of the entity and the environment, the applicable financial reporting framework, and the system of internal control forms the basis for the auditor's identification of risks of material misstatement. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial report as a whole, and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level.
- A208. Risks of material misstatements that do not relate pervasively to the financial report are risks of material misstatement at the assertion level. The identification of risks of material misstatement at the assertion level is performed before consideration of any controls. The auditor does so based on a preliminary assessment of inherent risk that involves identifying those risks for which there is a reasonable possibility of material misstatement. The assertions to which such risks of material misstatement relate are relevant assertions, and the classes of transactions, account balances and disclosures to which the relevant assertions relate are significant classes of transactions, account balances and disclosures.
- A209. While obtaining the understanding as required by paragraph 23, the auditor takes into account the inherent risk factors. Appendix 2 sets out examples, in the context of the inherent risk factors, of events and conditions that may indicate susceptibility to misstatement that may be material.

Considerations Specific to Public Sector Entities

- A210. For public sector entities, the identification of risks at the financial statement level may include consideration of matters related to the political climate, public interest and program sensitivity.

Significant Classes of Transactions, Account Balances and Disclosures, and their Relevant Assertions
(Ref: Para. 46)

- A211. The auditor determines the significant classes of transactions, account balances and disclosures by considering whether there are one or more risks of material misstatement related to the assertions for classes of transactions, account balances and disclosures expected in the financial report (i.e., whether there is a reasonable possibility of being subject to a misstatement that is material, individually or in combination with other misstatements). When there is a remote possibility of a material misstatement with respect to an assertion, there are no identified risks of material misstatement and the assertion is not relevant. In determining the relevant assertions, the auditor considers the information gathered from the auditor's risk

assessment procedures about the identified risks of material misstatement and the assertions that they may affect.

- A212. In determining significant classes of transactions, account balances and disclosures from the identified risks of material misstatement, understanding how the inherent risk factors affect the classes of transactions, account balances and disclosures enables the auditor to consider which related assertions may be subject to risks of material misstatement (see paragraph A83).
- A213. The auditor may also use automated techniques to confirm whether all significant classes of transactions and account balances have been identified by, for example, analysing an entire population of transactions to identify their nature, source, size and volume. By applying automated techniques, the auditor may, for example identify that an account with a zero balance at period end actually was comprised of numerous offsetting transactions and journal entries occurring during the period thus indicating that the account balance or class of transactions may be significant (e.g., a “loan processing suspense” account in a financial institution entity).

Identifying Significant Disclosures

- A214. Significant disclosures include both quantitative and qualitative disclosures for which there is one or more relevant assertions. Examples of significant disclosures that have qualitative aspects include disclosures about:
- Liquidity and debt covenants of an entity in financial distress.
 - Events or circumstances that have led to the recognition of an impairment loss.
 - Key sources of estimation uncertainty, including assumptions about the future.
 - The nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework, where, for example, new financial reporting requirements are expected to have a significant impact on the financial position and financial performance of the entity.
 - Share-based payment arrangements, including information about how any amounts recognised were determined, and other relevant disclosures.
 - Related parties, and related party transactions.
 - Sensitivity analysis, including the effects of changes in assumptions used in the entity’s valuation techniques intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount.

Assessing Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 47)

- A215. Because risks of material misstatement at the financial statement level have a pervasive effect on the financial report, it may not be possible to identify the specific assertions that are more susceptible to the risk (e.g., risk of management override of controls). In other cases, a number of assertions may be identified as susceptible to the risk, and which may therefore affect the auditor’s risk identification and assessment of risks of material misstatement at the assertion level.
- A216. The evaluation of whether risks identified relate pervasively to the financial report as required by paragraph 45(a) supports the auditor’s ability to perform the assessment of the risks of material misstatement at the financial statement level as required by paragraph 47. The determination of the effect of the risks of material misstatement at the financial statement level on the risks of material misstatement at the assertion level as required by paragraph 47(a) is taken into account in the auditor’s assessment of inherent risk at the assertion level in accordance with paragraph 48(b).

- A217. Risks of material misstatement due to fraud may be particularly relevant to the auditor's consideration of the risks of material misstatement at the financial statement level. For example, the risk of management override of controls may pervasively affect the risks of material misstatement at the assertion level, although the auditor may consider particular assertions to have a greater potential for misstatement based on greater susceptibility to management bias or fraud.
- A218. The auditor's identification and assessment of risks of material misstatement at the financial statement level is influenced by the auditor's understanding of the entity's system of internal control, including the outcome of the evaluations required by paragraphs 28 and 31(b) and any control deficiencies identified in accordance with paragraph 43. In particular, risks at the financial statement level may arise from deficiencies in the control environment or from external events or conditions, such as declining economic conditions.
- A219. The auditor's understanding of the control environment and other components of the system of internal control may raise doubts about the auditability of an entity's financial report, such that it may affect the auditor's opinion or be cause for withdrawal from the engagement. For example:
- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial report is such that an audit cannot be conducted.
 - Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial report.
- A220. ASA 705⁵⁶ establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

Assessing Risks of Material Misstatement at the Assertion Level

Assessing Inherent Risk (Ref: Para. 48)

Assessing the Likelihood and Magnitude of the Risks of Material Misstatement at the Assertion Level
(Ref: Para: 48(a))

- A221. The degree to which events or conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, the inherent risk factors affects the degree to which such events and conditions are susceptible to misstatement. The inherent risk factors influence the auditor's assessment of the likelihood and magnitude of misstatement for the identified risks of material misstatement at the assertion level. The greater the degree to which a class of transactions, account balance or disclosures is susceptible to material misstatement, the higher the inherent risk assessment is likely to be.
- A222. The relative degrees of the likelihood and magnitude of a possible misstatement determine where on the spectrum of inherent risk the risk of misstatement is assessed. The higher the combination of likelihood and magnitude, the higher the inherent risk; the lower the combination of likelihood and magnitude, the lower the inherent risk. When considering the potential magnitude of the misstatement, the quantitative and qualitative aspects of the potential misstatement may be relevant. A higher inherent risk assessment may also arise from different combinations of likelihood and magnitude, for example a higher risk assessment could result from a lower likelihood but a very high magnitude. Determining the combination of the likelihood and potential magnitude of a possible misstatement is a matter

⁵⁶ See ASA 705 *Modifications to the Opinion in the Independent Auditor's Report*.

of the auditor's professional judgement. Significant risks, which are identified in accordance with paragraph 49, are those close to the upper end of the spectrum of inherent risk.

- A223. Misstatements in assertions about classes of transactions, account balances or disclosures may be judged to be material due to size, nature or circumstances.
- A224. The assessment of inherent risks for individual risks of material misstatement in relation to audits of smaller and less complex entities may be such that a greater proportion of such risks are assessed close to the lower end of the spectrum of inherent risk.
- A225. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within relative categories along the spectrum of inherent risk, based on their assessment of inherent risk. These relative categories may be described in different ways, for example audit methodologies may use numerical categorisations (e.g., on a scale of one to ten), or the relative placement on the spectrum of inherent risk may be described (e.g., high, medium, low). Regardless of the method of categorisation used, the auditor's assessment of inherent risk is appropriate when the design and implementation of further audit procedures to address the identified risks of material misstatement at the assertion level is responsive to the assessment of inherent risk and the reasons for that assessment.
- A226. In assessing the identified risks of material misstatement at the assertion level, the auditor may conclude that some risks of material misstatement relate more pervasively to the financial report as a whole and potentially affect many assertions, in which case the auditor may update the identification of risks of material misstatement at the financial statement level.
- A227. In circumstances in which risks of material misstatement are identified as financial statement level risks due to their pervasive effect on a number of assertions and that effect is identifiable with specific assertions, the auditor takes into account the evaluation required by paragraph 47(b), including those assertions identified that are affected by those risks when assessing the inherent risk for risks of material misstatement at the assertion level.
(Ref: Para. 48(b))

Considerations specific to public sector entities

- A228. In exercising professional judgement as to the assessment of the risk of material misstatement, public sector auditors may consider the complexity of the regulations and directives, and the risks of non-compliance with authorities.

Significant Risks (Ref: Para. 49)

- A229. In determining significant risks, the auditor may first identify those assessed inherent risks that have been assessed close to the upper end of the spectrum of inherent risk. The determination of which of the assessed inherent risks are close to the upper end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgement, unless the risk is of a type specified to be treated as a significant risk in accordance with the requirements of another ASA (see paragraph A230). Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because these are likely to give rise to risks of material misstatement at the assertion level that are assessed as close to the lower end on the spectrum of inherent risk. However, risks of material misstatement that may be assessed as having higher inherent risk and may therefore be assessed as significant risks, may arise from matters such as the following:
- Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved.
 - Accounting estimates that have high estimation uncertainty or complex models.
 - Complexity in data collection and processing to support account balances.

- Account balances or quantitative disclosures that involve complex calculations
- Accounting principles that may be subject to differing interpretation.
- Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.

A230. Significant risks include those risks of material misstatement that are treated as significant in accordance with the requirements of other ASAs. ASA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.⁵⁷

Implications for the audit

A231. ASA 330 describes the consequences for further audit procedures of identifying a risk as significant. When a risk is assessed as a significant risk, the implications for the audit include the design and implementation of an appropriate response to address the assessed risk, which may include for example the use of more experienced engagement team members, including those with specialised skills, to perform audit procedures or audit work may involve the use of experts. In addition, the ASAs set out required responses, including:

- Controls that address significant risks are required to be identified as relevant to the audit in accordance with paragraph 39.
- ASA 330 requires controls that address significant risks to be tested in the current period (when the auditor intends to rely on the operating effectiveness of such controls) and substantive procedures to be planned and performed that are specifically responsive to the identified significant risk.⁵⁸
- ASA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk.⁵⁹
- ASA 260 requires communicating with those charged with governance about the significant risks identified by the auditor.⁶⁰
- ASA 701 requires the auditor to take into account significant risks when determining those matters that required significant auditor attention, which are matters that may be key audit matters.⁶¹
- Review of audit documentation by the engagement partner on or before the date of the auditor's report which allows significant matters, including significant risks, to be resolved on a timely basis to the engagement partner's satisfaction.⁶²
- ASA 600 requires more involvement by the group engagement partner if the significant risk relates to a component in a group audit and for the group engagement team to direct the work required at the component by the component auditor.⁶³

The nature, timing and extent of the involvement of individuals with specialised skills and knowledge may vary throughout the audit.

⁵⁷ See ASA 240, paragraphs 25-27.

⁵⁸ See ASA 330, paragraphs 15 and 21.

⁵⁹ See ASA 330, paragraph 7(b).

⁶⁰ See ASA 260, paragraph 15.

⁶¹ See ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraph 9.

⁶² See ASA 220, paragraphs 17 and A18.

⁶³ See ASA 600, paragraphs 30 and 31.

Proposed Auditing Standard ASA 315
Identifying and Assessing the Risks of Material Misstatement

Assessing Control Risk (Ref: Para. 50)

- A232. The auditor's intention to test the operating effectiveness of controls provides the basis for the auditor's assessment of control risk. In assessing control risk, the auditor takes into account the expectation about the operating effectiveness of the controls (based on the auditor's evaluation of the design effectiveness and implementation of the controls set out in paragraph 42).
- A233. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk. For example, if control risk is assessed as maximum, the auditor contemplates no expectation of the operating effectiveness of controls. If control risk is assessed at less than maximum, the auditor contemplates an expectation of the operating effectiveness of controls.
- A234. If a risk of material misstatement is addressed by one or more controls, the auditor takes into account whether one, or a combination of controls, will address the assessment of inherent risk.
- A235. The assessment of control risk takes into account the expected results from the auditor's planned tests of the operating effectiveness of controls relevant to the audit, including general IT controls. For controls relevant to the audit as determined in accordance with paragraph 39, and for which the auditor intends to test the operating effectiveness, the auditor may identify related general IT controls as relevant to the audit in accordance with paragraph 41. For example, when the auditor plans to test the operating effectiveness of an automated control, the auditor may also plan to test the operating effectiveness of the relevant general IT controls that support the continued functioning of that application control to address the risks arising from the use of IT, and to provide a basis for the auditor's expectation that the application control operated effectively throughout the period. When the auditor expects general IT controls that have been determined to be relevant to the audit to be ineffective, this determination may affect the auditor's assessment of control risk at the assertion level depending on whether the auditor is able to perform other tests to address those risks arising from the use of IT. Further guidance about the procedures that the auditor may perform in these circumstances is provided in ASA 330.⁶⁴

Risks for Which Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence
(Ref: Para. 51)

- A236. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial report. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.
- A237. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an information system that involves a high-degree of integration across its IT applications. In such cases:
- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.

⁶⁴ See ASA 330, paragraphs A29-A31.

Proposed Auditing Standard ASA 315
Identifying and Assessing the Risks of Material Misstatement

- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.
- A238. ASA 540 provides further guidance related to accounting estimates about risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence.⁶⁵
- A239. Paragraph 39 requires the identification of controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence to be relevant to the audit because the auditor is required, in accordance with ASA 330,⁶⁶ to design and perform tests of such controls.

Classes of Transactions, Account Balances and Disclosures that are Not Significant, but are Material
(Ref: Para. 52)

- A240. As explained in ASA 320,⁶⁷ materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances and disclosures. The auditor's determination of materiality is a matter of professional judgement, and is affected by the auditor's perception of the financial reporting needs of users of the financial report.⁶⁸ Classes of transactions, account balances or disclosures are quantitatively or qualitatively material if omitting, misstating or obscuring information about them could reasonably be expected to influence the economic decisions of users taken on the basis of the financial report as a whole.
- A241. There may be classes of transactions, account balances or disclosures that are quantitatively or qualitatively material but have not been determined to be significant classes of transactions, account balances or disclosures (i.e., there are no relevant assertions identified). For example, the entity may have a disclosure about executive compensation for which the auditor has not identified a risk of material misstatement. However, the auditor may determine that this disclosure is material based on the consideration in paragraph A240.
- A242. Audit procedures to address classes of transactions, account balances or disclosures that are quantitatively or qualitatively material but are not determined to be significant are addressed in ASA 330.⁶⁹ When a class of transactions, account balance or disclosure is determined to be significant as required by paragraph 46, the class of transactions, account balance or disclosure, is also treated as a material class of transactions, account balance or disclosure for the purposes of paragraph 18 of ASA 330.

Revision of Risk Assessment (Ref: Para. 53)

- A243. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. Paragraphs 16 and 17 of ASA 330 provide further guidance about evaluating the operating effectiveness of controls.

⁶⁵ See ASA 540, paragraphs A87-A89.

⁶⁶ See ASA 330, paragraph 8.

⁶⁷ See ASA 320, paragraph A1.

⁶⁸ See ASA 320, paragraph 4.

⁶⁹ See ASA 330, paragraph 18.

Documentation (Ref: Para. 54)

- A244. The manner in which the requirements of paragraph 54 are documented is for the auditor to determine using professional judgement. For example, in audits of smaller and less complex entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.⁷⁰ Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.⁷¹ The form and extent of the auditor's documentation is influenced by the nature, size and complexity of the entity and its system of internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.
- A245. More detailed documentation may be required where the auditor applies a higher level of professional judgement, for example when exercising professional judgement to support the rationale for difficult judgements made. However, the auditor is not required to document every inherent risk factor that was taken into account in identifying and assessing the risks of material misstatement at the assertion level.
- A246. For the audits of smaller and less complex entities, the form and extent of documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor may include those on which the auditor based the assessment of the risks of material misstatement.
- A247. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes

⁷⁰ See ASA 300 *Planning an Audit of a Financial Report*, paragraphs 7 and 9.

⁷¹ See ASA 330, paragraph 28.

Appendix 1

(Ref: Para. 23(a)(i), A57)

CONSIDERATIONS FOR UNDERSTANDING THE ENTITY AND ITS BUSINESS MODEL

The appendix provides further matters that the auditor may consider in understanding the entity and its business model.

Activities of the Entity

1. Examples of matters that the auditor may consider when obtaining an understanding of the activities of the entity (included in the entity's business model) include:
 - (a) Business operations such as:
 - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
 - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
 - Alliances, joint ventures, and outsourcing activities.
 - Geographic dispersion and industry segmentation.
 - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
 - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, superannuation and other post-employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
 - Research and development activities and expenditures.
 - Transactions with related parties.
 - (b) Investments and investment activities such as:
 - Planned or recently executed acquisitions or divestitures.
 - Investments and dispositions of securities and loans.
 - Capital investment activities.
 - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
 - (c) Financing and financing activities such as:
 - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
 - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.

- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.

Nature of Special-Purpose Entities

2. A special-purpose entity (sometimes referred to as a special-purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitisation of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As ASA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.⁷²
3. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

⁷² See ASA 550, paragraph A7.

Appendix 2

(Ref: Para. A60, A83, A209)

EVENTS AND CONDITIONS THAT MAY INDICATE SUSCEPTIBILITY TO RISKS OF MATERIAL MISSTATEMENT

In obtaining the understanding of the entity and its environment and the applicable financial reporting framework in accordance with paragraph 23, the auditor considers whether and, if so, how events and conditions are subject to by, or affected by, the inherent risk factors.

The following are examples of events and conditions that may indicate the existence of risks of material misstatement in the financial report, either at the financial statement level or the assertion level. The examples provided by inherent risk factor cover a broad range of events and conditions; however, not all events and conditions are relevant to every audit engagement and the list of examples is not necessarily complete. The events and conditions have been categorised by the inherent risk factor that may have the greatest effect in the circumstances. Importantly, due to the interrelationships among the inherent risk factors, the example events and conditions also are likely to be subject to, or affected by, other inherent risk factors to varying degrees.

Inherent Risk Factors at the Assertion Level

Complexity

Regulatory:

- Operations that are subject to a high degree of complex regulation.

Business model:

- The existence of complex alliances and joint ventures.

Applicable financial reporting framework:

- Accounting measurements that involve complex processes.

Transactions:

- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.

Subjectivity

Applicable financial reporting framework:

- A wide range of possible measurement criteria of an accounting estimate. For example, management's recognition of depreciation or construction income and expenses.
- Management's selection of a valuation technique or model for a non-current asset, such as investment properties.

Change

Economic conditions:

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.

Markets:

- Operations exposed to volatile markets, for example, futures trading.

Customer loss:

- Going concern and liquidity issues including loss of significant customers.

Industry model:

- Changes in the industry in which the entity operates.

Business model:

- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.

Geography

- Expanding into new locations.

Entity structure:

- Changes in the entity such as large acquisitions or reorganisations or other unusual events.
- Entities or business segments likely to be sold.

Human resources competence:

- Changes in key personnel including departure of key executives.

IT:

- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.

Applicable financial reporting framework:

- Application of new accounting pronouncements.

Uncertainty

Reporting:

- Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

Susceptibility to misstatement due to management bias or fraud

Reporting:

- Opportunities for management and employees to engage in fraudulent financial reporting, including omission, or obscuring, of significant information in disclosures.

Transactions:

- Significant transactions with related parties.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.

Other Inherent Risk Factors

- Constraints on the availability of capital and credit.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Investigations into the entity's operations or financial results by regulatory or government bodies.

Other events or conditions that may indicate risks of material misstatement at the financial statement level

- Lack of personnel with appropriate accounting and financial reporting skills.
- Control deficiencies, especially those not addressed by management.
- Past misstatements, history of errors or a significant amount of adjustments at period end.

Appendix 3

(Ref: Para. 16(f), 27–38, A51, A92, A105–A165)

UNDERSTANDING THE ENTITY’S SYSTEM OF INTERNAL CONTROL

1. This appendix further explains the components of, as well as the limitations of, the entity’s system of internal control as set out in paragraphs 16(f), 27–38, A51, A92 and A105–A165, as they relate to a financial statement audit.

Components of the System of Internal Control

Control Environment

2. The control environment encompasses the following elements:
 - (a) *How the entity demonstrates a commitment to integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behaviour are the product of the entity’s ethical and behavioural standards or codes of conduct, how they are communicated (e.g., through policy statements), and how they are reinforced in practice (e.g., through management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts). The communication of entity policies on integrity and ethical values may include the communication of behavioural standards to personnel through policy statements and codes of conduct and by example.
 - (b) *How those charged with governance demonstrate independence from management and exercise oversight of the entity’s system of internal control.* An entity’s control consciousness is influenced significantly by those charged with governance. Considerations include whether there are sufficient individuals who are independent from management and objective in their evaluations and decision-making; how those charged with governance identify and accept oversight responsibilities and whether those charged with governance retain oversight responsibility for management’s design, implementation and conduct of the entity’s system of internal control. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures.
 - (c) How the entity has established, with oversight from those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of its objectives. This includes considerations about:
 - Key areas of authority and responsibility and appropriate lines of reporting;
 - Policies relating to appropriate business practices, knowledge and experience of key personnel, and resource provided for carrying out duties; and
 - Policies and communications directed at ensuring that all personnel understand the entity’s objectives, know how their individual actions interrelate and contribute to those objectives, and recognise how and for what they will be held accountable.

The appropriateness of an entity’s organisation and governance structure depends, in part, on its size and the nature of its activities.

- (d) *How the entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with its objectives.* This includes how the entity ensures the individuals have the knowledge and skills necessary to accomplish the tasks that define the individual's job, such as:
- Standards for recruiting the most qualified individuals – with an emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour.
 - Training policies that communicate prospective roles and responsibilities, including practices such as training schools and seminars that illustrate expected levels of performance and behaviour; and
 - Periodic performance appraisals driving promotions that demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.
- (e) *How the entity holds individuals accountable for their internal control responsibilities in pursuit of its objectives.* This may be accomplished through, for example:
- Mechanisms to communicate and hold individuals accountable for performance of internal control responsibilities and implement corrective actions as necessary;
 - Establishing performance measures, incentives and rewards for those responsible for internal control, including how the measures are evaluated and maintain their relevance;
 - How pressures associated with the achievement of internal control objectives impact the individual's responsibilities and performance measures; and
 - How the individuals are disciplined as necessary.

The appropriateness of the above matters will be different for every entity depending on its size, the complexity of its structure and the nature of its activities.

Entity's Risk Assessment Process

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial report in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial report.
4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial information consistent with the assertions of management in the financial report. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
 - *Changes in operating environment.* Changes in the regulatory, economic or operating environment can result in changes in competitive pressures and significantly different risks.
 - *New personnel.* New personnel may have a different focus on or understanding of the system of internal control.

- *New or revamped information system.* Significant and rapid changes in the information system can change the risk relating to the entity's system of internal control.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into production processes or the information system may change the risk associated with the entity's system of internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with the entity's system of internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with the entity's system internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial report.
- *Use of IT.* Risks relating to:
 - Maintaining the integrity of data and information processing (including cyber security risks);
 - Risks to the entity business strategy that arise if the entity's IT strategy does not effectively supporting the entity's business strategy; or
 - Changes or interruptions in the entity's IT environment or turnover of IT personnel or when the entity does not make necessary updates to the IT environment or such updates are not timely.

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

5. An important management responsibility is to establish and maintain the entity's system of internal control on an ongoing basis. Management's process to monitor the system of internal control includes considering whether controls are operating as intended and that they are modified as appropriate for changes in conditions. The entity's process to monitor the system of internal control may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.
6. When distinguishing between a monitoring activity and a control in the control activities component, the underlying details of the activity are considered, especially where the activity involves some level of supervisory review. As also explained in the application material, supervisory reviews are not automatically classified as monitoring activities and it may be a matter of judgement whether a review is classified as a control in the control activities component or a monitoring activity. For example, the intent of a monthly completeness control in the control activities component would be to detect and correct errors, where a

monitoring activity would ask why errors are occurring and assign management the responsibility of fixing the process to prevent future errors. In simple terms, a control in the control activities component responds to a specific risk, whereas a monitoring activity assesses whether controls within each of the five components of the system of internal control are operating as intended.

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

Use of internal audit

8. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organisation, 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. These matters may be set out in an internal audit charter or terms of reference.
9. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, the system of internal control and governance processes. If so, the internal audit function may play an important role in the entity's process to monitor the system of internal control. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

The Information System and Communication

10. The information system relevant to financial reporting encompasses policies, procedures and records that:
 - Identify and record all valid transactions.
 - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
 - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial report.
 - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
 - Present properly the transactions and related disclosures in the financial report.
 - Capture, process and disclose information about events and conditions other than transactions.
11. The quality of the information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
12. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to the entity's system of internal control may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda.

Communication also can be made electronically, orally, and through the actions of management.

Control Activities

13. Controls in the control activities component consist of application controls and general IT controls, both of which may be manual or automated in nature, and may pertain to the following:

- *Authorisation and approvals.* An authorisation affirms that a transaction is valid (i.e. it represents an actual economic event or is within an entity's policy). An authorisation typically takes the form of an approval by a higher level of management or of verification and a determination if the transaction is valid. For example, a supervisor approves an expense report after reviewing whether the expenses seem reasonable and within policy. An example of an automated approval is where an invoice unit cost is automatically compared with the related purchase order unit cost within a pre-established tolerance level. Invoices within the tolerance level are automatically approved for payment. Those invoices outside the tolerance level are flagged for additional investigation.
- *Reconciliations* – Reconciliations compare two or more data elements and, if differences are identified, action is taken to bring the data into agreement. Reconciliations generally address the completeness or accuracy of processing transactions.
- *Verifications* – Verifications compare two or more items with each other or compare an item with a policy, and perform a follow-up action when the two items do not match or the item is not consistent with policy. Verifications generally address the completeness, accuracy, of validity of processing transactions.
- Physical or logical controls, including those that address security of assets against unauthorised access, acquisition, use or disposal. Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorisation for access to computer programs and data files (i.e., logical access).
 - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation depends on circumstances such as when assets are highly susceptible to misappropriation.

- *Segregation of duties.* Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

For example, a manager authorising credit sales is not responsible for maintaining accounts receivable records or handling cash receipts. If one person is able to perform all these activities he or she could, for example, create a fictitious sale that could go undetected. Similarly, salespersons should not have the ability to modify product price files or commission rates.

Sometimes segregation is not practical, cost effective, or feasible. For example, smaller and less complex entities may lack sufficient resources to achieve ideal segregation, and the cost of hiring additional staff may be prohibitive. In these situations, management institutes alternative controls. In the example above, if the salesperson can modify product price files, a detective control activity can be put in place to have personnel unrelated to the sales function periodically review whether and under what circumstances the salesperson changed prices.

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

Benefits of IT

15. Generally, IT benefits an entity's system of internal control by enabling an entity to:
- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
 - Enhance the timeliness, availability, and accuracy of information;
 - Facilitate the additional analysis of information;
 - Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
 - Reduce the risk that controls will be circumvented; and
 - Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

Limitations of internal control

16. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgement in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of the system of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
17. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in an IT application that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
18. Further, in designing and implementing controls, management may make judgements on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Appendix 4

(Ref: Para. A193)

CONSIDERATIONS FOR UNDERSTANDING GENERAL IT CONTROLS

This appendix provides further matters that the auditor may consider in understanding general IT controls.

1. The nature of the general IT controls (GITCs) typically implemented for each of the aspects of the IT environment
 - (a) Applications

General IT controls at the IT application layer will correlate to the nature and extent of application functionality and the access paths allowed in the technology. For example, more controls will be relevant for highly-integrated IT applications with complex security options than a legacy IT application supporting a small number of account balances with access methods only through transactions.
 - (b) Database

General IT controls at the database layer typically address risks arising from the use of IT related to unauthorised updates to financial reporting information in the database through direct database access or execution of a script or program.
 - (c) Operating system

General IT controls at the operating system layer typically address risks arising from the use of IT related to administrative access, which can facilitate the override of other controls. This includes actions such as compromising other user's credentials, adding new, unauthorised users, loading malware or executing scripts or other unauthorised programs.
 - (d) Network

General IT controls at the network layer typically address risks arising from the use of IT related to network segmentation, remote access, and authentication. Network controls may be relevant when an entity has web-facing applications used in financial reporting. Network controls are also may be relevant when the entity has significant business partner relationships or third party outsourcing, which may increase data transmissions and the need for remote access.
2. Examples of general IT controls that may be exist by IT process include:
 - (a) Process to manage access:
 - Authentication

Controls that ensure a user accessing the IT application or other aspect of the IT environment is using their own log-in credentials (i.e., the user is not using another user's credentials).
 - Authorisation

Controls that allow users to access the information necessary for their job responsibilities and nothing further, which facilitates appropriate segregation of duties.

- Provisioning
Controls to authorise new users and modifications to existing users' access privileges.
 - Deprovisioning
Controls to remove user access upon termination or transfer.
 - Privileged access
Controls over administrative or powerful users' access.
 - User access reviews
Controls to recertify or evaluate user access for ongoing authorisation over time.
 - Security configuration controls
Each technology generally has key configuration settings that help restrict access to the environment.
 - Physical access
Controls over physical access to the data centre and hardware, as such access may be used to override other controls.
- (b) Process to manage program or other changes to the IT environment
- Change management process
Controls over the process to design, program, test and migrate changes to a production (i.e., end user) environment.
 - Segregation of duties over change migration
Controls that segregate access to make and migrate changes to a production environment.
 - Systems development or acquisition or implementation
Controls over initial IT application development or implementation (or in relation to other aspects of the IT environment).
 - Data conversion
Controls over the conversion of data during development, implementation or upgrades to the IT environment.
- (c) Process to manage IT Operations
- Job scheduling
Controls over access to schedule and initiate jobs or programs that may affect financial reporting.

- Job monitoring
Controls to monitor financial reporting jobs or programs for successful execution.
- Backup and recovery
Controls to ensure backups of financial reporting data occur as planned and that such data is available and able to be accessed for timely recovery in the event of an outage or attack.
- Intrusion detection
Controls to monitor for vulnerabilities and or intrusions in the IT environment

EXPOSURE DRAFT

ED 02/18
(August 2018)

Proposed Auditing Standard ASA 2018-1 *Amendments to Australian Auditing Standards*

Issued for Comment by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be received by no later than 15 October 2018. Comments should be addressed to:

The Chairman
Auditing and Assurance Standards Board
PO Box 204, Collins Street West
Melbourne Victoria 8007 AUSTRALIA

Formal Submissions

Submissions should be lodged online via the “Work in Progress-Open for Comment” page of the Auditing and Assurance Standards Board (AUASB) website (www.auasb.gov.au/Work-In-Progress/Open-for-comment.aspx) as a PDF document and Word document.

A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AUASB website: www.auasb.gov.au

Contact Details

Auditing and Assurance Standards Board
Podium Level 14, 530 Collins Street
Melbourne Victoria 3000
AUSTRALIA

Phone: (03) 8080 7400
E-mail: enquiries@auasb.gov.au

Postal Address:
PO Box 204, Collins Street West
Melbourne Victoria 8007
AUSTRALIA

COPYRIGHT

© 2018 Auditing and Assurance Standards Board (AUASB). The text, graphics and layout of this Exposure Draft are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source as being the AUASB.

Requests and enquiries concerning reproduction and rights for commercial purposes should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Otherwise, no part of this Exposure Draft may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

This Exposure Draft reproduces substantial parts of Exposure Draft *Proposed International Standard on Auditing 315 (Revised)* issued by the International Auditing and Assurance Standards Board (IAASB) and published by the International Federation of Accountants (IFAC), in the manner described in the statement on Conformity with International Standards on Auditing. The AUASB acknowledges that IFAC is the owner of copyright in the International Standard on Auditing incorporated in this Exposure Draft throughout the world.

All existing rights in this material are reserved outside Australia. Reproduction outside Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use only.

Further information and requests for authorisation to reproduce this Exposure Draft for commercial purposes outside Australia should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Any decision to approve a request may also require the agreement of IFAC.

ISSN 1030-603X

CONTENTS

PREFACE

AUTHORITY STATEMENT

CONFORMITY WITH INTERNATIONAL STANDARDS ON AUDITING

	<i>Paragraphs</i>
Application	1-2
Operative Date	3
Introduction	
Scope of this Auditing Standard	4
Objective	5
Definition	6
Amendments to Auditing Standards	
Amendments to ASA 200	7-15
Amendments to ASA 240	16-34
Amendments to ASA 330	35-69
Appendix 1: Other Conforming and Consequential Amendments	

PREFACE

Reasons for Issuing ED 02/18

The AUASB issues exposure draft ED 02/18 of proposed Auditing Standard ASA 2018-1 *Amendments to Australian Auditing Standards* pursuant to the requirements of the legislative provisions and the Strategic Direction explained below.

The AUASB is a non corporate Commonwealth entity of the Australian Government established under section 227A of the *Australian Securities and Investments Commission Act 2001*, as amended (ASIC Act). Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislation Act 2003*.

Under the Strategic Direction given to the AUASB by the Financial Reporting Council (FRC), the AUASB is required, inter alia, to develop auditing standards that have a clear public interest focus and are of the highest quality. Under the Strategic Direction, the AUASB is required to have regard to any programme initiated by the IAASB for the revision and enhancement of the International Standards on Auditing (ISAs) and to make appropriate consequential amendments to the Australian Auditing Standards.

Main Proposals

This proposed Auditing Standard makes amendments to the requirements and/or application and other explanatory material and/or appendices the of the following Auditing Standards:

- | | |
|---------|---|
| ASA 200 | <i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards</i> (Issued October 2009 and amended to December 2015); |
| ASA 240 | <i>The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report</i> (Issued October 2009 and amended to May 2017); and |
| ASA 330 | <i>The Auditor's Responses to Assessed Risks</i> (Issued October 2009 and amended to December 2015). |

Conforming and consequential amendments to other Australian Auditing Standards have been presented in Appendix 1. These changes, in the view of the AUASB, are generally straight forward as they are largely definition changes so have been presented in table format for practicality.

The amendments arise from proposed changes by the International Auditing and Assurance Standards Board (IAASB) in Proposed International Standard on Auditing 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement*.

For background to, and explanation of, the conforming and consequential amendments proposed in ED 02/18, refer to Explanatory Memorandum *Exposure Draft 01/18: Identifying and Assessing the Risks of Material Misstatement and Exposure Draft 02/18: Proposed Auditing Standard ASA 2018-1 Amendments to Australian Auditing Standards*.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 15 December 2020.

Request for Comments

Comments are invited on this Exposure Draft of the proposed issuance of ASA 2018-1 *Amendments to Australian Auditing Standards* by no later than 15 October 2018. The AUASB is seeking comments from respondents on the following questions:

ED 02/18 Conforming and Consequential Amendments

The IAASB has asked for constituents views on:

1. With respect to the proposed conforming and consequential amendments to:
 - (a) ASA 200¹ and ASA 240, are these appropriate to reflect the corresponding changes made in proposed ASA 315?
 - (b) ASA 330, are the changes appropriate in light of the enhancements that have been made in proposed ASA 315, in particular as a consequence of the introduction of the concept of general IT controls relevant to the audit?
 - (c) The other ASAs as presented in Appendix 1, are these appropriate and complete?
2. Do you support the proposed revisions to paragraph 18 of ASA 330 to apply to classes of transactions, account balances or disclosures that are ‘quantitatively or qualitatively material’ to align with the scope of the proposed stand-back in proposed ASA 315?
3. Effective Date – Recognizing that ED 01/18 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods beginning at least 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged.

Australian Specific

The AUASB asks for constituents views on:

4. Have applicable laws and regulations been appropriately addressed in the proposed standard?
5. Are there any references to relevant laws or regulations that have been omitted?
6. Whether there are any laws or regulations that may, or do, prevent or impede the application of the proposed standard, or may conflict with the proposed standard?
7. What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the requirements of this proposed standard? If significant costs are expected, the AUASB would like to understand:
 - (a) Where those costs are likely to occur;
 - (b) The estimated extent of costs, in percentage terms; and
 - (c) Whether expected costs outweigh the benefits to the users of audit services?
8. What, if any, implementation guidance auditors would like the AUASB to issue in conjunction with the release of ASA 315 (specific questions/examples would be helpful).

¹ Conforming amendments to ASA 200, paragraph A42 will be presented with the conforming amendments to ASA 540.

9. Are there any other significant public interest matters that constituents wish to raise?

The AUASB prefers that respondents express a clear opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on the above matters. The AUASB regards both supportive and critical comments as essential to a balanced review of the proposed Auditing Standard.

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes this Auditing Standard ASA 2018-1 *Amendments to Australian Auditing Standards* pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001* and section 336 of the *Corporations Act 2001*.

Conformity with International Standards on Auditing

This Auditing Standard has been made for Australian legislative purposes and accordingly there is no equivalent International Standard on Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board of the International Federation of Accountants (IFAC).

AUDITING STANDARD ASA 2018-1

Amendments to Australian Auditing Standards

Application

1. This Auditing Standard applies to:
 - (a) an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with the *Corporations Act 2001*; and
 - (b) an audit of a financial report, or a complete set of financial statements, for any other purpose.
2. This Auditing Standard also applies, as appropriate, to an audit of other historical financial information.

Operative Date

3. This Auditing Standard is operative for financial reporting periods commencing on or after 15 December 2020.

Introduction

Scope of this Auditing Standard

4. This Auditing Standard makes amendments to Australian Auditing Standards. The amendments arise from conforming and consequential changes arising from the issuance of ASA 315 *Identifying and Assessing the Risks of Material Misstatement*.

Objective

5. The objective of this Auditing Standard is to make amendments to the following Auditing Standards:
 - (a) ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* (Issued October 2009 and amended to December 2015);
 - (b) ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* (Issued October 2009 and amended to May 2017); and
 - (c) ASA 330 *The Auditor's Responses to Assessed Risks* (Issued October 2009 and amended to December 2015).

Definition

6. For the purposes of this Auditing Standard, the meanings of terms are set out in each Auditing Standard and in the *AUASB Glossary*.

Amendments to Auditing Standards

Amendments to ASA 200

7. Existing paragraph 7 is amended to read as follows:

The Australian Auditing Standards contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The Australian Auditing Standards require that the auditor exercise professional judgement and maintain professional scepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial report based on conclusions drawn from the audit evidence obtained.

8. Existing paragraph 13 is amended to read as follows:

For the purposes of this Auditing Standard, the following terms have the meanings attributed below:

- (n) Risk of material misstatement means the risk that the financial report is materially misstated prior to audit. This consists of two components, described as follows at the assertion level:
- (i) ...
 - (ii) Control risk means the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's ~~internal~~ controls.

9. Existing footnote 17 to paragraph A30 is amended to read as follows:

See ASA 315 *Identifying and Assessing the Risks of Material Misstatement* ~~through Understanding the Entity and Its Environment~~, paragraph 21 9.

10. Existing paragraph A40 is amended to read as follows:

Inherent risk is influenced by the characteristics of events or conditions that affect the susceptibility to misstatement of an higher for some assertions about a and related classes of transactions, account balances, or and disclosures than for others, before consideration of controls (i.e. inherent risk factors). Depending on the extent to which the assertion is subject to, or affected by, such inherent risk factors, the level of inherent risk varies along the spectrum of inherent risk. The auditor determines significant classes of transactions, account balances and disclosures, and their relevant assertions, as part of the process of identifying and assessing the risks of material misstatement. For example, it may be higher for complex calculations or for accounts balances consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty may be identified as significant account balances, and the auditor's assessment of inherent risk for the related risks at the assertion level may be higher because of the high estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more

susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

11. Existing paragraph A41 is amended to read as follows:

Control risk is a function of the effectiveness of the design, implementation and maintenance of ~~internal~~ controls by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial report. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial report, because of the inherent limitations of ~~internal~~ controls. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The Australian Auditing Standards provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.¹⁸

12. The following paragraph and footnote(*) are inserted following existing paragraph A43:

Risks of material misstatement are assessed at the assertion level in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.*

* See ASA 330, paragraph 6

13. Existing footnote 21 to paragraph A52 is amended to read as follows:

See ASA 315, paragraphs ~~517-224~~9.

14. Existing paragraph A66 is amended to read as follows:

For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” refers to an entity which typically possesses qualitative characteristics such as:

(a) ...

(b) One or more of the following:

- (i) Straightforward or uncomplicated transactions;
- (ii) Simple record-keeping;
- (iii) Few lines of business and few products within business lines;
- (iv) Simpler systems of ~~Few~~ internal controls;
- (v) Few levels of management with responsibility for a broad range of controls; or
- (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

15. The following paragraph is inserted following existing paragraph A67:

ASA 315 incorporates considerations specific to audits of smaller entities when such entities are also less complex (i.e. smaller entities for which the majority of the characteristics in paragraph A66(b) apply). Accordingly, in this context, ASA 315 refers to ‘smaller and less complex entities’.

Amendments to ASA 240

16. Existing paragraph 7 is amended to read as follows:

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override controls ~~procedures~~ designed to prevent similar frauds by other employees.

17. Existing footnote 6 to paragraph 16 is amended to read as follows:

See ASA 315, paragraph ~~22~~40

18. Existing paragraph 17 and footnote 7 are amended to read as follows:

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, ~~the applicable financial reporting framework and including~~ the entity’s system of internal control, required by ASA 315⁷, the auditor shall perform the procedures in paragraphs ~~2418–4525~~ to obtain information for use in identifying the risks of material misstatement due to fraud.

19. Existing paragraph 21 is amended to read as follows:

Unless all of those charged with governance are involved in managing the entity,⁸ 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~~ controls that management has established to mitigate these risks. (Ref: Para. A20-A22)

20. Existing footnote 9 to paragraph 26 is amended as follows:

See ASA 315, paragraphs ~~25~~, ~~47(a)~~ and ~~48~~

21. Existing paragraph 28 is amended (including the insertion of a new footnote *) to read as follows:

The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall ~~obtain an understanding of the entity’s related~~ identify the entity’s controls, including control activities, relevant to that address such risks as controls relevant to the audit, and evaluate their design and determine whether they have been implemented.^{*} (Ref: Para. A32–A33)

^{*} See ASA 315, paragraphs 39(b) and 42.

22. Existing paragraph 45 is amended to read as follows:

The auditor shall include the following in the audit documentation¹² ~~of the auditor's understanding of the entity and its environment and of the identification and~~ the assessment of the risks of material misstatement required by ASA 315:¹³

- (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial report to material misstatement due to fraud; ~~and~~
- (b) The identified and assessed risks of material misstatement due to fraud at the financial report level and at the assertion level; ~~and~~
- (c) Controls identified to be relevant to the audit because they address assessed risks of material misstatement due to fraud.

23. Existing footnote 13 to paragraph 45 is amended to read as follows:

See ASA 315, paragraph ~~5432~~

24. Existing paragraph A8 is amended to read as follows:

Maintaining professional scepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance ~~where~~ when such controls are identified to be controls relevant to the audit. Due to the characteristics of fraud, the auditor's professional scepticism is particularly important when considering the risks of material misstatement due to fraud.

25. Existing footnote 17 to paragraph A19 is amended to read as follows:

See ASA 315, paragraphs ~~186(a)~~ and ~~3423~~, and ASA 610, *Using the Work of Internal Auditors*.

26. Existing paragraph A20 is amended to read as follows:

Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control and compliance with the law. In many circumstances, 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 the controls that address such risks.~~ Since the responsibilities of those charged with governance and management may vary by entity and by the circumstances, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.¹⁸

27. Existing paragraph A21 is amended to read as follows:

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 controls that address~~ over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making enquiries of those charged with governance.

28. Existing paragraph A23 is amended to read as follows:

In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment, the applicable financial reporting framework

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

29. Existing paragraph A26 is amended (including the insertion of two footnotes, * and ^) to read as follows:

Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. 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 rationalise the fraudulent action.

Fraud risk factors related to incentives, pressures or opportunities may arise from conditions that create susceptibility to misstatements due to management bias or fraud (which is an inherent risk factor).^{*} Alternatively, fraud risk factors may relate to conditions within the entity's system of internal control that provide opportunity to commit fraud or that may affect management's attitude or ability to rationalise fraudulent actions. Risk factors reflective of an attitude that permits rationalisation of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information through, for example, the required understanding of the entity's control environment.[^] Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

* See ASA 315, paragraph 16(f).

^ See ASA 315, paragraphs 27-28.

30. Existing paragraph A33 is amended to read as follows:

It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. ~~In doing so, In identifying the controls relevant to the audit that address the risks of material misstatement due to fraud,~~ the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding identifying these controls, and evaluating their design and determining whether they have been implemented, may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial report may contain material misstatement due to fraud.

31. Existing paragraph A43 is amended (including the insertion of a new footnote *) to read as follows:

Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries^{*} is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, where IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

* See ASA 315, paragraph 39(c).

32. Existing paragraph A44 is amended to read as follows:

When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- *The identification and assessment of the risks of material misstatement due to fraud – the presence of fraud risk factors and other information obtained during the auditor’s identification and assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.*
- *Controls that have been implemented over journal entries and other adjustments – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.*
- *The entity’s financial reporting process and the nature of evidence that can be obtained – for many entities routine processing of transactions involves a combination of manual and automated ~~steps and procedures~~ controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated ~~procedures and~~ controls. Where information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.*
- *The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial report that do not have account numbers, or (e) containing round numbers or consistent ending numbers.*
- *The nature and complexity of the accounts – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.*
- *Journal entries or other adjustments processed outside the normal course of business – nonstandard journal entries may not be subject to the same level of internal nature and extent of controls as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.*

Amendments to ASA 240 Appendix 1

33. Under the heading *Examples of Fraud Risk Factors*, the following paragraph is inserted following the existing paragraph:

Fraud risk factors related to incentives or pressures typically arise from conditions that create susceptibility to misstatement due to management bias or fraud (which is an inherent risk factor). Fraud risk factors related to opportunities may also arise from other identified inherent risk factors (e.g., complexity or uncertainty may create opportunities that result in

susceptibility to misstatement due to fraud). Fraud risk factors related to opportunities may also relate to conditions within the entity's system of internal control, such as limitations or deficiencies in the entity's internal control that create such opportunities. Fraud risk factors related to attitudes or rationalisations may arise, in particular, from limitations or deficiencies in the entity's control environment.

34. Under the heading *Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting* and sub-heading *Opportunities*, the fourth paragraph is amended to read as follows:

~~Internal control components are deficient~~ Deficiencies in internal control as a result of the following:

- Inadequate ~~monitoring of controls~~ process to monitor the entity's system of internal control, including automated controls and controls over interim financial reporting (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.

35. Under the heading *Risk Factors Relating to Misstatements Arising from Misappropriation of Assets* and sub-heading *Opportunities*, the second paragraph is amended to read as follows:

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

- ...
- ...

36. Under the heading *Risk Factors Relating to Misstatements Arising from Misappropriation of Assets* and sub-heading *Attitudes/Rationalisation*, the second point is amended to read as follows:

- Disregard for ~~internal~~ controls over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.

Amendments to ASA 240 Appendix 2

37. Under the heading *Consideration at the Assertion Level* the ninth point is amended to read as follows:

If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of material misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.

Amendments to ASA 330

38. Existing footnote 1 to paragraph 1 is amended to read as follows:

See ASA 315, *Identifying and Assessing the Risks of Material Misstatement* ~~through Understanding the Entity and Its Environment~~.

39. Existing paragraph 6 is amended to read as follows:

The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4–A8; A42–A52)

40. Existing paragraph 7 is amended to read as follows:

In designing the further audit procedures to be performed, the auditor shall:

- (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each significant class of transactions, account balance, and disclosure, including:
 - (i) The likelihood and magnitude of material misstatement due to the particular characteristics of the ~~relevant~~ significant class of transactions, account balance, or disclosure (that is, the inherent risk); and
 - (ii) Whether the risk assessment takes account of ~~relevant~~ controls that address the risk of material misstatement (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9–A18)
- (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

41. Existing paragraph 8 is amended to read as follows:

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of ~~relevant~~ controls if:

- (a) ...
- (b) ...

42. Existing paragraph 10 is amended to read as follows:

In designing and performing tests of controls, the auditor shall:

- (a) Perform other audit procedures in combination with enquiry to obtain audit evidence about the operating effectiveness of the controls, including:
 - (i) How the controls were applied at relevant times during the period under audit;
 - (ii) The consistency with which they were applied; and
 - (iii) By whom or by what means they were applied. (Ref: Para. A26–A29a)
- (b) To the extent not already addressed, determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30–A31)

43. Existing paragraph 13 is amended to read as follows:

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- (a) The effectiveness of other ~~elements~~ components of the entity's system of internal control, including the control environment, the entity's process to monitoring of the system of internal controls, and the entity's risk assessment process;
- (b) ...
44. Existing paragraph 14 is amended to read as follows:
- If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance and reliability of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing enquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:
- (a) ...
- (b) ...
45. Existing paragraph 16 is amended to read as follows:
- When evaluating the operating effectiveness of ~~relevant~~ controls upon which the auditor intends to rely, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)
46. Existing paragraph 17 is amended to read as follows:
- If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific enquiries to understand these matters and their potential consequences, and shall determine whether: (Ref: Para. A41)
- (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
- (b) Additional tests of controls are necessary; or
- (c) The ~~potential~~ risks of material misstatement need to be addressed using substantive procedures.
47. Existing paragraph 18 is amended to read as follows:
- Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each ~~material~~ class of transactions, account balance, and disclosure that is quantitatively or qualitatively material. (Ref: Para. A42–A47)
48. Existing paragraph 27 is amended to read as follows:
- If the auditor has not obtained sufficient appropriate audit evidence as to the risk of material misstatement related to a material financial report relevant assertion about a class of transactions, account balance or disclosure, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial report.

49. Existing paragraph A1 is amended to read as follows:

Overall responses to address the assessed risks of material misstatement at the financial report level may include:

- Emphasising to the engagement team the need to maintain professional scepticism.
- Assigning more experienced staff or those with special skills or using experts.
- ~~Providing more supervision~~ Changes to the nature, timing and extent of direction and supervision of members of the engagement team and the review of the work performed.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Changes to the overall audit strategy as required by ASA 300, or planned audit procedures, and may include changes to:
 - The auditor's determination of performance materiality in accordance with ASA 320.
 - The auditor's plans to tests the operating effectiveness of controls, and the persuasiveness of audit evidence needed to support the planned reliance on the operating effectiveness of the controls, particularly when deficiencies in the control environment or the entity's monitoring activities are identified.
 - The nature, timing and extent of substantive procedures. For example, it may be appropriate to perform substantive procedures at or near the date of the financial report when the risk of material misstatement is assessed as higher.
- ~~Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.~~

50. Existing paragraph A4 is amended to read as follows:

The auditor's assessment of the identified risks of material misstatement at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that:

- (a) ...
- (b) ...
- (c) ...

However, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each ~~material~~ class of transactions, account balance, and disclosure that is quantitatively or qualitatively material.

51. Existing paragraph A9 is amended (including the insertion of a new footnote *) to read as follows:

ASA 315 requires that the auditor's assessment of the risks of material misstatement at the assertion level is performed by assessing inherent risk and control risk. The auditor assesses inherent risk by assessing the likelihood and magnitude of a material misstatement taking into account how, and the degree to which, identified events or conditions relating to significant classes of transactions, account balances or disclosures are subject to, or affected by, the

inherent risk factors.* The auditor's assessed risks, including the reasons for those assessed risks, may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of material misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of material misstatement of the occurrence assertion.

* See ASA 315, paragraph 48.

52. Existing paragraph A10 is amended to read as follows:

The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of ~~internal~~ the operating effectiveness of controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

53. Existing paragraph A18 is amended to read as follows:

In the case of smaller entities, there may not be many controls ~~activities~~ that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of controls ~~activities~~ or of ~~other~~ components of the system of internal control may make it impossible to obtain sufficient appropriate audit evidence.

54. Existing paragraph A20 is amended to read as follows:

Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an relevant assertion, and the auditor intends to rely upon those controls. If substantially different controls were used at different times during the period under audit, each is considered separately.

55. Existing paragraph A24 is amended to read as follows:

In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level.³ This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of ~~relevant~~ controls that address the risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

56. Existing footnote 3 is amended to read as follows:

See ASA 315, paragraph ~~51~~30.

57. Existing paragraph A27 is amended to read as follows:

The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of controls activities, such as ~~automated controls activities performed by a computer~~. In such circumstances, audit evidence about operating effectiveness may be obtained through enquiry in combination with other audit procedures such as observation or the use of CAATs.

58. Existing paragraph A29 is amended to read as follows:

Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated controls can be expected to function consistently unless the ~~program~~ IT application (including the tables, files, or other permanent data used by the ~~program~~ IT application) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests ~~might~~ may include testing the general IT controls related to the IT application. ~~determining that:~~

- ~~Changes to the program are not made without being subject to the appropriate program change controls;~~
- ~~The authorised version of the program is used for processing transactions; and~~
- ~~Other relevant general controls are effective.~~

~~Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorised access has not occurred during the period.~~

59. The following paragraph is inserted following existing paragraph A29:

Similarly, the auditor may perform tests of controls that address risks of material misstatement related to the integrity of the entity's data, or the completeness and accuracy of the entity's system-generated reports, or to address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence. These tests of controls may include tests of general IT controls that address the matters in paragraph 10(a). When this is the case, the auditor may not need to perform any further testing to obtain audit evidence about the matters in paragraph 10(a).

60. The following paragraph (including a footnote *) is inserted following existing paragraph A29 and the above insertion:

When the auditor determines that a general IT control is deficient, the auditor may consider the nature of the related risk(s) arising from the use of IT that were identified in accordance with ASA 315* to provide the basis for the design of the auditor's additional procedures to determine whether the underlying controls affected by the deficient general IT control functioned throughout the period. Such procedures may address determining whether:

- The related risk(s) arising from IT has occurred. For example, if users have unauthorised access to an IT application (but cannot access or modify the system logs that track access), the auditor may inspect the system logs to obtain audit evidence that those users did not access the IT application during the period.

- There are any alternate or redundant general IT controls, or any other controls, that address the related risk(s) arising from the use of IT. If so, the auditor may determine such controls to be relevant to the audit (if not already relevant to the audit) and therefore evaluate their design, determine that they have been implemented and perform tests of their operating effectiveness. For example, if a general IT control related to user access is deficient, the entity may have an alternate control whereby IT management reviews end user access reports on a timely basis. Circumstances when an application control may address a risk arising from the use of IT may include when the information that may be affected by the general IT control deficiency can be reconciled to external sources (e.g., a bank statement) or internal sources not affected by the general IT control deficiency (e.g., a separate IT application or data source).

* See ASA 315, paragraph 41.

61. Existing paragraph A30 is amended to read as follows:

In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls (e.g., general IT controls). As explained in paragraphs A29 to A29b, general IT controls may have been determined to be relevant to the audit in accordance with ASA 315 because of their support of the operating effectiveness of automated controls or due to their support in maintaining the integrity of information used in the entity's financial reporting, including system-generated reports. The requirement in paragraph 10(b) acknowledges that the auditor may have already tested certain indirect controls to address the matters in paragraph 10(a). For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorised credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, general IT controls) are described as "indirect" controls.

62. Existing paragraph A31 is deleted.

63. Existing paragraph A32 is amended to read as follows:

Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of controls in the entity's process to monitoring of the system of internal controls.

64. Existing paragraph A35 is amended to read as follows:

In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance and reliability. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, enquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

65. Existing paragraph A36 is amended to read as follows:

Changes may affect the relevance and reliability of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

66. Existing paragraph A38 is amended to read as follows:

In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- A deficiency in the entity's process to monitoring of the system of internal controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT controls.

67. Existing paragraph A42 is amended (including the insertion of a new footnote *) to read as follows:

Paragraph 18 requires the auditor to design and perform substantive procedures for each ~~material~~ class of transactions, account balance, and disclosure, ~~irrespective of the assessed risks of material misstatement, that is quantitatively or qualitatively material.~~ For significant classes of transactions, account balances and disclosures, substantive procedures may have already been performed because paragraph 6 requires the auditor to design and perform further audit procedures that are responsive to the assessed risks of material misstatement at the assertion level. Accordingly, substantive procedures are required to be designed and performed in accordance with paragraph 18:

- When the further audit procedures designed and performed in accordance with paragraph 6 for significant classes of transactions, account balances or disclosures did not include substantive procedures; or
- For each class of transactions, account balance or disclosure that is not a significant class of transactions, account balance or disclosure, but that has been identified as quantitatively or qualitatively material in accordance with ASA 315.*

This requirement reflects the facts that: (a) the auditor's assessment of risk is judgemental and so may not identify all risks of material misstatement; and (b) there are inherent limitations to ~~internal~~ controls, including management override.

* See ASA 315, paragraph 52.

68. The following paragraph is inserted following existing paragraph A42:

In designing the substantive procedures to be performed, the auditor's consideration of the assertion(s) in which a possible misstatement could occur, and if it were to occur, the effect of that misstatement would be most material, may assist in identifying the appropriate nature, timing and extent of the procedures to be performed.

69. Existing paragraph A45 is amended to read as follows:

The ~~nature~~ assessment of the risk ~~and or the nature of the~~ assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial report amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

70. Existing paragraph A46 is amended to read as follows:

Because the assessment of the risk of material misstatement takes account of ~~internal~~ controls upon which the auditor intends to rely, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

71. Existing paragraph A56 is amended to read as follows:

Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other ~~relevant~~ controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

72. Existing paragraph A60 is amended to read as follows:

An audit of financial report is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example:

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgement about the risk assessments and may indicate a significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognised risk of material misstatement.

In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks of material misstatement ~~for all or some of~~ and the effect on the significant classes of transactions, account balances, or disclosures and ~~related their relevant~~ assertions. ASA 315 contains further guidance on revising the auditor's risk assessment.⁷

73. Existing footnote 7 to paragraph A60 is amended to read as follows:

See ASA 315, paragraph ~~543~~4.

74. Existing paragraph A62 is amended to read as follows:

The auditor's judgement as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial report.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control.

Appendix 1

(Ref: Para.)

OTHER CONFORMING AND CONSEQUENTIAL AMENDMENTS

Conforming and consequential amendments to Australian Auditing Standards, other than ASA 200, ASA 240 and ASA 330 have been presented in this Appendix. These changes, in the view of the AUASB, are generally straight forward as they are largely changes to definitions so have been presented in table format for practicality.

Three tables are presented within this appendix. Table 1 shows all other conforming and consequential amendments. Where the other conforming and consequential amendments presented within Table 1 include changes in addition to definition changes, further information is shown within Table 2 or Table 3.

Table 1		
Extant Term in the ASAs	Change Made in Proposed ASA 315	Relevant Paragraph(s) Where Change is Proposed
Changes to Names of Components of the System of Internal Control		
Monitoring of controls (extant ASA 315, para's 22–24)	The entity's process to monitor the system of internal control (ED 01/18, para's 32–34)	ASA 210: ² Para. A18 (refer to Table 2) ASA 402: ³ Para. A33 – last bullet Para. A34
The information system, including the related business processes, relevant to financial reporting, and communication (extant ASA 315, para. 18)	The information system, and communication (ED 01/18, para. 35)	ASA 210: Para. A18 (refer to Table 2)
Other Changes		
Monitoring of controls ⁴ (extant ASA 315, para's 22–24)	Controls within the entity's process to monitor the system of internal control (ED 01/18, para's 32–34)	ASA 402: A39 – first bullet ASA 600: ⁵ Appendix 2, para. 1, 8th bullet (refer to Table 2)
Control activities (extant ASA 315, para. 20)	Controls (ED 01/18, para. 38)	ASA 250: ⁶ Para. A23 ASA 265: Para A3 (2nd and 3rd sentences) (refer to Table 2) ASA 500: Para. A17 ASA 501: ⁷ Para. A4 ASA 550: ⁸ Para. A20 ASA 600: Appendix 2, para. 1 (7th bullet)

² ASA 210 *Agreeing the Terms of Audit Engagements*.

³ ASA 402 *Audit Considerations Relating to an Entity Using a Service Organisation*.

⁴ Where this is used to describe what the entity does, as opposed to the name of the component

⁵ ASA 600 *Special Considerations – Audits of a Group Financial Report*.

⁶ ASA 250 *Consideration of laws and Regulations in an Audit of a Financial Report*

⁷ ASA 501 *Audit Evidence – Specific Considerations for Inventory and Segment Information*

⁸ ASA 550 *Related Parties*

Table 1		
Extant Term in the ASAs	Change Made in Proposed ASA 315	Relevant Paragraph(s) Where Change is Proposed
		Appendix 5, Matters that are relevant to the conduct of the work of the component auditor (1st bullet) <u>ASA 610:</u> ⁹ Para. A3 Para. A10
Control activities ¹⁰ (extant ASA 315, para. 20)	Controls in the control activities component (ED 01/18, para. 38)	<u>ASA 265:</u> Para. A3 (first sentence) (refer to Table 2)
Relevant control activities (extant ASA 315, para. 20)	Controls relevant to the audit (ED 01/18, para. 38)	<u>ASA 300:</u> ¹¹ Para. A21
The auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (extant ASA 315, para. 9)	The auditor shall evaluate whether such information remains relevant and reliable as audit evidence for the current audit. (ED 01/18, para. 21)	<u>ASA 500:</u> Para. A1
Internal control (extant ASA 315, para. 4(c))	The system of internal control (ED 01/18, para. 16(l))	<u>ASA 210:</u> Para. A18 (refer to Table 2) <u>ASA 265:</u> Para. 1 (second sentence) Para. 2 (first sentence) <u>ASA 620:</u> ¹² Para. A4 (first bullet)
Internal control relevant to the audit (extant ASA 315, para. 12)	Controls relevant to the audit (ED 01/18, para. 26)	<u>ASA 402:</u> Para 14(b)
Internal control relevant to the audit. (extant ASA 315, para. 12)	System of internal control relevant to financial reporting (ED 01/18, para. 25)	<u>ASA 260:</u> ¹³ Para A13, 3rd bullet <u>ASA 265:</u> Para 2 (first sentence) <u>ASA 402:</u> Para. 1 Para. 7(a) Para. 10 (refer to Table 2)
Extant elements of the auditor's understanding of the 'entity and its environment' Extant ASA 315, para. 11 (refer to Table 3)	Revised elements of the auditor's understanding of the 'entity and its environment' (ED 01/18, para. 23 (refer to Table 3))	All the changes in this section are presented in Table 3 <u>ASA 550:</u> Para. A12 <u>ASA 600:</u> Para. A23 <u>ASA 720:</u> ¹⁴ Para. A31

⁹ ASA 610 Using the Work of Internal Auditors

¹⁰ The proposed change in respect of this reference to 'control activities' is slightly different when compared to the proposed change in the previous row. This is due to the particular construction of the first sentence of ASA 265 paragraph A3; however, the meaning of 'controls' remains the same. Also refer to Table 2.

¹¹ ASA 300 Planning an Audit of a Financial Report

¹² ASA 620 Using the Work of an Auditor's Expert

¹³ ASA 260 Communication with Those Charged with Governance

¹⁴ ASA 720 The Auditor's Responsibilities Relating to Other Information

Table 1		
Extant Term in the ASAs	Change Made in Proposed ASA 315	Relevant Paragraph(s) Where Change is Proposed
Understanding the entity and its environment ¹⁵ (extant ASA 315, para. 11)	Understanding the entity and its environment, the applicable financial reporting framework and the system of internal control (ED 01/18, para. 17)	<u>ASA 230:</u> Para. A17 (refer Table 2) <u>ASA 600:</u> Para. 17 <u>ASA 620:</u> Para. A4 (first bullet) <u>ASA 720 (Revised):</u> Para. A31 (refer Table 3)
Require special audit consideration (in context of significant risks) (extant ASA 315, para. 4(e))	<i>Change as appropriate or delete</i> (ED 01/18, para. 16(k) and A10)	All the changes in this section are presented in Table 2 <u>ASA 260:</u> Para. A12 <u>ASA 550:</u> Para. A28 <u>ASA 600:</u> Para. A6 <u>ASA 610:</u> Para. A21 <u>ASA 701:</u> Para. A20
Relevant controls (extant ASA 315, para 13–heading)	Controls relevant to the audit (ED 01/18, para. 26)	<u>ASA 402:</u> Para. 10 (refer Table 2) Para. 12 (c) and (d) Para. A19 Para. A22 (hanging paragraph) Para. A29 Para. A30 (1st and 2nd sentences) Para. A33
Relevant controls (extant ASA 315, para 13–heading)	<i>Change as appropriate</i>	<u>ASA 530:</u> ¹⁶ Appendix 2, factor 1 (refer Table 2) <u>ASA 550:</u> Para. A34 – last sentence (refer Table 2)
Identifying and assessing the risks of material misstatement through understanding the entity and its environment (name of standard)	Identifying and assessing the risks of material misstatement	<u>ASA 210:</u> Footnote 14 <u>ASA 220:</u> ¹⁷ Footnote 13 <u>ASA 230:</u> Footnote 5 Appendix <u>ASA 250:</u> ¹⁸ Footnote 4 <u>ASA 260 (Revised):</u> Footnote 4 <u>ASA 265:</u> Footnote 1

¹⁵ When reference is made to the auditor's understanding of the entity and its environment, and in the specific context used, are intended to be inclusive of the auditor's understanding of internal control

¹⁶ ASA 530 Audit Sampling

¹⁷ ASA 220 Quality Control for an Audit of a Financial Report and Other Historical Financial Information

¹⁸ ASA 250 Consideration of Laws and Regulations in an Audit of Financial Statements

Table 1		
Extant Term in the ASAs	Change Made in Proposed ASA 315	Relevant Paragraph(s) Where Change is Proposed
		<u>ASA 300:</u> Footnote 4 <u>ASA 320:</u> ¹⁹ Footnote 3 <u>ASA 402:</u> Footnote 1 <u>ASA 500:</u> Footnote 1
Identifying and assessing the risks of material misstatement through understanding the entity and its environment (name of standard)	Identifying and assessing the risks of material misstatement	<u>ASA 505:</u> ²⁰ Footnote 14 <u>ASA 510:</u> ²¹ Footnote 4 <u>ASA 520:</u> ²² Footnote 1 <u>ASA 550:</u> Footnote 1 <u>ASA 570:</u> ²³ Footnote 3 <u>ASA 600:</u> Footnote 7 <u>ASA 610:</u> Footnote 1 <u>ASA 700:</u> Footnote 35 <u>ASA 701:</u> Footnote 5 <u>ASA 720:</u> Footnote 11 <u>ASA 800:</u> Footnote 5
Relevant assertion (this is now a defined term)	<i>As appropriate</i>	Refer to Table 2: ASA 265 para. A8
<i>Aspects of the entity's</i> information system (ASA 315, para. 18)	Alignment to the requirements to understanding the information system. (ED 01/18, para. 35)	<u>ASA 402:</u> Para. 3 (refer to Table 2)

¹⁹ ASA 320 Materiality in Planning and Performing an Audit

²⁰ ASA 505 External Confirmations

²¹ ASA 510 Initial Audit Engagements—Opening Balances

²² ASA 520 Analytical Procedures

²³ ASA 570 *Going Concern*

Table 2

Description of components of the system of internal control

1. ASA 210, para. A18

It is for management to determine what internal control is necessary to enable the preparation of the financial report. The term “internal control” encompasses a wide range of activities within components of the system of internal control that may be described as the control environment; the entity’s risk assessment process; the entity’s process to monitor the system of internal control, the information system, including the related business processes relevant to financial reporting, and communication; and control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.¹⁵ An entity’s internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

ASA 210, footnote 15

See ASA 315, paragraph A9959 and Appendix 34

Controls within the entity’s process to monitor the system of internal control

2. ASA 600, Appendix 2, paragraph 1 (8th bullet)

Group-Wide Controls

1. Group-wide controls may include a combination of the following:

- Regular meetings between group and component management to discuss business developments and to review performance.
- ...
- Controls within the group’s process to monitor ~~Monitoring the system of internal~~ controls, including activities of the internal audit function and self-assessment programs.

Control activities

3. ASA 265, para. A3

While the concepts underlying controls in the control activities component in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of controls ~~activities~~ are not necessary because of controls applied by management. For example, management’s sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed controls ~~activities~~.

Table 2

‘Controls relevant to the audit’, and the ‘system of internal control’

4. ASA 402, para. 10

When obtaining an understanding of the system of internal control relevant to ~~the audit~~ financial reporting in accordance with ASA 315,⁴ the user auditor shall evaluate the design and implementation of ~~relevant~~ controls relevant to the audit at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation. (Ref: Para. A12–A14)

ASA 402, footnote 4

See ASA 315, paragraph ~~25~~¹².

Describing aspects of the entity and its environment in extant ASA 315:

5. ASA 230, para. A17

When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its environment, the applicable financial reporting framework, and the entity’s system of internal control, the overall audit strategy and audit plan, materiality determined in accordance with ASA 320,⁹ assessed risks, significant matters noted during the audit, and conclusions reached.

References to risks that ‘require special audit consideration’

6. ASA 260, para. A12

Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they were determined to be significant risks ~~require special audit consideration~~. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

7. ASA 550, para. A28

Sharing Related Party Information with the Engagement Team (Ref: Para. 17)

Relevant related party information that may be shared among the engagement team members includes, for example:

- The identity of the entity’s related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may be determined to be significant risks ~~require special audit consideration~~, in particular transactions in which management or those charged with governance are financially involved.

Table 2

8. ASA 600, para. A6

The group engagement team may also identify a component as likely to include significant risks of material misstatement of the group financial report due to its specific nature or circumstances. ~~(that is, risks that require special audit consideration¹⁴)~~. For example, a component could be responsible for foreign exchange trading and thus expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.

ASA 600, footnote 14

~~See ASA 315, paragraphs 27–29.~~

9. ASA 610, para. A21

As explained in ASA 315,²² ~~significant risks require special audit consideration~~ are risks assessed close to the upper end of the spectrum of inherent risk and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgement. 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.

ASA 610, footnote 22

See ASA 315 ~~(as amended)~~, paragraph 4(k)(e).

10. ASA 701, para. A20

ASA 315 defines a significant risk as an identified ~~and assessed~~ risk of material misstatement:

- For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which one or a combination of the inherent risk factors affect the likelihood of a misstatement occurring or the magnitude of potential misstatement should that misstatement occur; or
- That is to be treated as a significant risk in accordance with the requirement of other ASAs;²³ ~~that, in the auditor's judgement, requires special audit consideration. Areas of significant management judgement and significant unusual transactions may often be identified as significant risks.~~ Significant risks are ~~therefore~~ often areas that require significant auditor attention.

ASA 701 footnote *

See ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*, paragraph 27 and ISA 550 *Related Parties*, paragraph 18.

Extant references to relevant controls

11. ASA 530

Appendix 2, factor 1

An increase in the extent to which the auditor's risk assessment takes into account ~~relevant~~ controls that address the risk of material misstatement.

Table 2

12. ASA 550, para. A34

Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the ASA 330 requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of ~~relevant~~ controls,²⁶ the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

Extant references to 'relevant assertion'

13. ASA 265, para. A8

A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure, ~~relevant~~ assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

Alignment to the requirements to understanding the information system

14. ASA 402, para. 3

Services provided by a service organisation are relevant to the audit of a user entity's financial report when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

- (a) How information relating to significant classes of transactions, account balances and disclosures flows through the user entity's information system, whether manually or using IT, and whether obtained from within or outside the general ledger and subsidiary ledgers. The classes of transactions in the user entity's operations that are significant to the user entity's financial report; This includes when the service organisation's services affect how:
 - (i) ~~(b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial report; Transactions of the user entity are initiated, and how information about them is recorded, processed, corrected as necessary, and incorporated in the general ledger and reported in the financial report; and~~
 - (ii) Information about events and conditions, other than transactions, is captured, processed and disclosed by the user entity in the financial report.

Table 2

- | | |
|---|--|
| <ul style="list-style-type: none"> (b) (d) (c) (d) (f) | <ul style="list-style-type: none"> (e) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial report and other supporting records relating to the flows of information in paragraph 3(a) that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger; How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial report; (e) The financial reporting process used to prepare the user entity's financial report from the records described in paragraph 3(b), including as it relates to disclosures and to accounting estimates relating to significant classes of transactions, account balances and disclosures accounting estimates and disclosures; and <u>The entity's IT environment relevant to (a) to (c) above.</u> Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. |
|---|--|

Table 3

Describing aspects of the entity and its environment in extant ASA 315 (*changes to the description of the entity and its environment are described below*):

1. ASA 550, para. A12

However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the enquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this ASA. In such a case, however, the auditor's enquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with ASA 315 to obtain information regarding the entity's organisational structure, ownership, governance and business model:

- The entity's ownership and governance structures;
- The types of investments that the entity is making and plans to make; and
- The way the entity is structured and how it is financed.

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's enquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

2. ASA 600, para. A23

Matters about Which the Group Engagement Team Obtains an Understanding (Ref: Para. 17)

ASA 315 contains guidance on matters the auditor may consider when obtaining an understanding of the entity and its environment, including:

- The entity's organisational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT;
- Relevant industry, regulatory, and other external factors that affect the entity;;
- The relevant measurement used, internally and externally, to assess and review of the entity's financial performance; and
- The including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and.¹⁷

Appendix 2 of this ASA contains guidance on matters specific to a group including the consolidation process.

ASA 600, footnote 17

See ASA 315, paragraphs ~~A17-A41~~ A49-A88.

Table 3

3. ASA 720, para. A31

The auditor's knowledge obtained in the audit includes the auditor's understanding of the entity and its environment, the applicable financial reporting framework, and including the entity's system of internal control, obtained in accordance with ASA 315.¹¹ ASA 315 sets out the auditor's required understanding, which includes such matters as obtaining an understanding of:

- (a) The entity's organisational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT;
- (b) ~~The~~ Relevant industry, regulatory, and other external factors;
~~The nature of the entity;~~
~~The entity's selection and application of accounting policies;~~
~~The entity's objectives and strategies;~~
- (c) The relevant measures used, internally and externally, to assess measurement and review of the entity's financial performance; and
- (d) The applicable financial reporting framework; and
- (e) The entity's system of internal control.

ASA 720, footnote 11

See ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, paragraphs ~~2341~~ 2512.

Proposed amendments to the auditor's required understanding of 'the entity and its environment'

The following describes extant elements of the auditor's understanding of the 'entity and its environment' – ASA 315 paragraph 11:

The Entity and Its Environment

The auditor shall obtain an understanding of the following:

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A25–A30)
- (b) The nature of the entity, including:
 - (i) its operations;
 - (ii) its ownership and governance structures;
 - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - (iv) the way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial report. (Ref: Para. A31–A35)

Table 3

- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A36)
- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A37-A43)
- (e) The measurement and review of the entity's financial performance. (Ref: Para. A44-A49)

The following describes the revised elements of the auditor's understanding of the 'entity and environment' – ED 01/18 paragraph 23:

The auditor shall perform risk assessment procedures to obtain an understanding of the entity and its environment and the applicable financial reporting framework. In doing so, the auditor shall obtain an understanding of the following matters to provide an appropriate basis for understanding the classes of transactions, account balances and disclosures to be expected in the entity's financial report:

- (a) The entity and its environment, including:
 - (i) The entity's organisational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT; (Ref: Para A49-A63)
 - (ii) Relevant industry, regulatory and other external factors; and (Ref: Para. A64-A69)
 - (iii) The relevant measures used, internally and externally, to assess the entity's financial performance. (Ref: Para. A70-A78)
- (b) The applicable financial reporting framework, including: (Ref: Para.A79-A82)
 - (i) How it applies in the context of the nature and circumstances of the entity and its environment, including how events or conditions are subject to, or affected by, the inherent risk factors; and (Ref: Para.A83-A88)
 - (ii) The entity's accounting policies and any changes thereto, including the reasons for any changes to the entity's accounting policies.

Changes will also be made to the AUASB Glossary as needed.

PROPOSED TIMETABLE FOR ED 01/18 AND 02/18

31 July 2018	AUASB teleconference to approve ED 01/18 and ED 02/18
6 August 2018	Issue ED 01/18 and 02/18 with a 70 day comment period ie. closing 15 October
17 September – 12 October 2018	Roundtables in Perth, Adelaide, Canberra, Brisbane, Sydney, Melbourne (in conjunction with ASA 540)
15 October 2018	Comment period closes
24 October 2018	Draft ED IAASB submission sent to AUASB
29 October 2018	AUASB Teleconference to approve submission to IAASB
2 November 2018	Send final submission to IAASB



AUASB Board Meeting Summary Paper

AGENDA ITEM NO. **4**

Meeting Date: 31 July 2018

Subject: ED 03/18 Proposed Auditing Standard ASA 540 *Auditing Accounting Estimates and Related Disclosures*

ED 04/18 Proposed Auditing Standard 2018-2 *Amendments to Australian Auditing Standards*

Date Prepared: 25 July 2018

☒ **Action Required**

☐ **For Information Purposes Only**

Agenda Item Objectives

To consider and approve for issue:

1. ED 03/18 Proposed Auditing Standard ASA 540 *Auditing Accounting Estimates and Related Disclosures* (ED 03/18);
2. ED 04/18 Proposed Auditing Standard 2018-2 *Amendments to Australian Auditing Standards* (ED 04/18); and
3. Explanatory Memorandum ED 03/18 and ED 04/18 (including agreement on the questions on exposure).

Background

On 22 June 2018, the IAASB approved ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* and related conforming amendments to other ISAs. This is subject to approval by the Public Interest Oversight Board (PIOB) in September 2018 to confirm that due process has been followed with proper regard to the public interest.

In accordance with its mandates under section 227 of the *ASIC Act 2001* and the Financial Reporting Council's (FRC) Strategic Direction, the AUASB's policy is to adopt the IAASB's auditing standards (ISAs), unless there are compelling reasons not to do so; and to amend the ISAs only when there are compelling reasons to do so.

At the June 2018 AUASB meeting, the AUASB raised 3 primary concerns in relation to the finalisation of ISA 540. The AUASB technical group consider that these areas have been addressed by the IAASB and are outlined in Agenda Item 4(a).

This document contains preliminary views and/or AUASB Technical Group recommendations to be considered at a meeting of the AUASB, and does not necessarily reflect the final decisions of the AUASB. No responsibility is taken for the results of actions or omissions to act on the basis of reliance on any information contained in this document (including any attachments), or for any errors or omissions in it.

Actions required of the AUASB

The AUASB is asked to consider and approve for issue:

1. ED 03/18 and 04/18; and
2. Explanatory Memorandum

Considerations

NZAuASB

The AUASB has liaised with the NZAuASB technical group who have raised no issues of concern on the adoption of ISA 540 and conforming and consequential amendments. The NZAuASB has already exposed ISA 540 in March 2017 in line with the IAASB's exposure draft, and their plan is to approve for issue, ISA 540 and conforming and consequential amendments at the NZAuASB September 2018 meeting, subject to PIOB approval.

“Compelling Reasons” Assessment

The AUASB technical group have not identified any compelling reasons, in accordance with the [Principles of Convergence to International Standards of the International Auditing and Assurance Standards Board \(IAASB\) and Harmonisation with the Standards of the New Zealand Auditing and Assurance Standards Board \(NZAuASB\) \(August 2014\)](#), to be made to modify IAASB standards. This document is included as agenda item 4(e).

The technical group propose the timetable reflected below:

Timetable for AUASB – Australian Release of Standard Date	Action
20 July	IAASB releases ISA 540 and conforming and consequential amendments (pre PIOB approval)
27 July	AUASB technical group circulates Australian EDs to AUASB
31 July	Teleconference: AUASB approves EDs for issue for 70 day period.
6 August	ED issued for 70 day period
September/October	Outreach along with ISA 315 (aligns with 315 project)
24 September	PIOB approves for issue ISA 540 and conforming amendments
Early October	IAASB issues final standards after PIOB approval
15 October	End of AUASB 70 day comment period (aligns with 315 project)
Week beginning 29 October	AUASB teleconference - disposition of comments and final comments (aligns with 315 project) (to be confirmed)
December AUASB meeting	AUASB to approve standards
Early – mid December	Release of standards (2 months after the IAASB)

AUASB Technical Group Recommendations

Approval to issue Australian Exposure drafts 03/18 and 04/18 and Explanatory Memorandum.

Material Presented

Agenda Item 4	AUASB Board Meeting Summary Paper
Agenda Item 4(a)	AUASB Board Meeting Summary Paper Attachment
Agenda Item 4(b)	Exposure Draft 03/18 Proposed Auditing Standard ASA 540 <i>Auditing Accounting Estimates and Related Disclosures</i>
Agenda Item 4(c)	Exposure Draft 04/18 Proposed Auditing Standard 2018-2 <i>Amendments to Australian Auditing Standards</i>
Agenda Item 4(d)	Explanatory Memorandum
Agenda Item 4(e)	Principles of Convergence to International Standards of the International Auditing and Assurance Standards Board (IAASB) and Harmonisation with the Standards of the New Zealand Auditing and Assurance Standards Board (NZAuASB)

Action Required

No.	Action Item	Deliverable	Responsibility	Due Date	Status
1.	Approve the Exposure Drafts 03/18 and 04/18	Approval	AUASB		31 July 2018



Attachment to AUASB Board Meeting Summary Paper

AGENDA ITEM NO. 4(a)

Meeting Date: 31 July 2018

Subject: ED 03/18 Proposed Auditing Standard ASA 540 *Auditing Accounting Estimates and Related Disclosures*
ED 04/18 Proposed Auditing Standard 2018-2 *Amendments to Australian Auditing Standards*

Date Prepared: 25 July 2018

Update on matters raised by the AUASB at the 13 June 2018 AUASB meeting on ISA 540 *Auditing Accounting Estimates and Related Disclosures*

A. Key Issues Raised

1. Paragraphs 26(b)/A111/A112/A118 – Development of a range or point estimate by the auditor

Matter Raised by the AUASB at the 13 June 2018 AUASB meeting

The AUASB raised concerns with the wording in paragraph 26(b) ‘*to the extent possible*’ and associated application material. The AUASB considered this wording to inappropriately shift the onus from preparer to auditor where the preparer has not fulfilled their role. The AUASB considered that the requirements of paragraph 26(b) went beyond what is expected under the financial reporting frameworks, which is not considered appropriate. The development of a range or point estimate for reporting purposes is the responsibility of the preparer. Additionally, this wording diminished the exercise of auditor’s professional judgement in circumstances where the auditor may consider that they have gathered sufficient appropriate audit evidence to form a view that a misstatement exists rather than then fulfilling the role of the preparer. Furthermore, ISA 540 needed clarification that in circumstances where sufficient and appropriate audit evidence cannot be obtained from management, then the auditor will assess the impact of this and it may result in a modification to the opinion in the auditor’s report based on a scope limitation.

Update on Matter

The IAASB have made changes to the wording of the requirement in paragraph 27 and associated application paragraphs in A115 - A117. The AUASB technical group considers these changes address the AUASB’s primary concern, reducing the requirement for the auditor to develop a point estimate or range “to the extent possible” to “to the extent practical, without compromising the auditor’s independence”. This is a lower bar and provides an appropriate exclusion for the auditor where it is impracticable to independently determine the point estimate.

This document contains preliminary views and/or AUASB Technical Group recommendations to be considered at a meeting of the AUASB, and does not necessarily reflect the final decisions of the AUASB. No responsibility is taken for the results of actions or omissions to act on the basis of reliance on any information contained in this document (including any attachments), or for any errors or omissions in it.

Furthermore the clarifications in the updated application guidance adds a point covering where it is not appropriate for the auditor to develop an auditor's point estimate or range, rather than just not possible in the previous version of ISA 540 presented earlier.

The AUASB technical group considers these changes remove the key issue that the AUASB identified which effectively compelled the auditor in all possible scenarios to develop the point estimate or range.

2. Embedded requirements relating to the work required to review the work of Management's experts in A129.

Matter Raised by the AUASB at the 13 June 2018 AUASB meeting

With reference to the inclusion of a new application paragraph A129 in relation to management's experts, including:

- a. the significant uplift in audit effort in relation to the work of management's experts was beyond the requirements of ISA 500 *Audit Evidence*, bringing into question the purpose of a management's expert and why they would be used; and
- b. the wording in the application material was akin to a requirement and accordingly should be contained within the requirements of the standard and not within the application material.

Update on Matter

Amendments were made to paragraph 30 but also the associated application material paragraphs A130 – A 132. The key wording change here is the addition of Paragraph A131 which now means the requirements in ISA 540 around the development of a point estimate or range by the expert are only a reference point and not a requirement. To clarify this matter the IAASB task force has added additional material linking this part of the standard back to ISA 500 and the requirements around the use of a management expert in this standard. The AUASB technical group considers that the AUASB's significant concern has been addressed, but it may create an implementation challenge as auditors will need to be aware of the requirements in both ISA 500 and ISA 540 when evaluating the work of management experts for estimates.

3. Effective date

Matter Raised by the AUASB at the 13 June 2018 AUASB meeting

The AUASB discussed the proposed effective period and supported an extension of the effective period to be appropriate. The AUASB supported an effective period beginning on or after 15 December 2019.

Update on Matter

The standard's effective date has been changed to periods beginning on or after 15 December 2019.

B. Other Matters Raised

There were other matters raised by the AUASB that were not considered to be key issues which were communicated to the IAASB task force for their consideration. The matters raised and where the final ISA 540 has landed is summarised below:

1. With reference to paragraphs 18(a) and 21: The AUASB suggested a reference to disclosures within paragraph 20(a) to be consistent with the requirements in relation to testing options included at paragraphs 17(b) and 17(c). The AUASB considered that the requirements currently contained within paragraph 20 does not address disclosures.

The IAASB has not made any change in relation to the point above. The AUASB Technical Group does not have concerns in this area as the AUASB technical group considers that obtaining audit

This document contains preliminary views and/or AUASB Technical Group recommendations to be considered at a meeting of the AUASB, and does not necessarily reflect the final decisions of the AUASB. No responsibility is taken for the results of actions or omissions to act on the basis of reliance on any information contained in this document (including any attachments), or for any errors or omissions in it.

evidence from events occurring up to the date of auditor's report may be a testing approach for a low risk / non-complex estimate.

2. With reference to paragraph 33: The AUASB considered the stand back requirements to be more granular than the objectives set out in paragraph 11 and considered that the 2 paragraphs should be more closely aligned.
The IAASB has not made any change in relation to the point above. The AUASB Technical Group does not have concerns in this area, paragraph 11 is the high level objectives, and paragraph 33 contains the detailed requirements.
3. Paragraph A88: The second bullet point, the AUASB questioned why electronic initiation, recording, processing or reporting of information was amplified as an example of a circumstance where substantive procedures alone are cannot provide sufficient appropriate audit evidence.
The IAASB has not made any change in relation to the point above. The AUASB Technical Group does not have concerns in this area.
4. With reference to paragraph A128 and using information from an external information source, the AUASB considered that the example provided is not appropriate and created a level of granularity that is generally not practical and appears to set a very high bar for information authentication.
The IAASB has not made any change in relation to the point above.
5. Paragraph A137: The AUASB considered that this paragraph should be deleted in the context of an overall stand back, it reads that the auditor is expected to have as much evidence as the preparer had to originate the estimate and its disclosures.
This paragraph has been deleted in the final version of ISA 540.
6. Paragraph A139: The AUASB considered that this application material should be lifted into a requirement following paragraph 34.
The IAASB has not made any change in relation to the point above and the paragraph remains in application material.
7. The terms verify, calibrate and validate appeared throughout the standard. These terms imply absolute (100%) rather than reasonableness, the AUASB suggests that these terms are revisited (examples: A51, Appendix 1 paragraph 5).
The term calibrate is no longer used in the final standard, the term verify appears in paragraph A90 and the term validate appears in paragraph A39. Both words are not used in the requirements but in application material.
8. A number of AUASB members considered that there has been substantial change to the principles of the exposed ED ISA 540 and accordingly considers that IAASB due process should require the re-exposure of ISA 540.
The IAASB considered the issue but voted by a majority not to re-expose this document.

This document contains preliminary views and/or AUASB Technical Group recommendations to be considered at a meeting of the AUASB, and does not necessarily reflect the final decisions of the AUASB. No responsibility is taken for the results of actions or omissions to act on the basis of reliance on any information contained in this document (including any attachments), or for any errors or omissions in it.

EXPOSURE DRAFT

ED 03/18

(August 2018)

Proposed Auditing Standard ASA 540

Auditing Accounting Estimates and Related Disclosures

Issued for Comment by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be received by no later than 15 October 2018. Comments should be addressed to:

The Chair
Auditing and Assurance Standards Board
PO Box 204, Collins Street West
Melbourne Victoria 8007 AUSTRALIA

Formal Submissions

Submissions should be lodged online via the “Work in Progress-Open for Comment” page of the Auditing and Assurance Standards Board (AUASB) website (www.auasb.gov.au/Work-In-Progress/Open-for-comment.aspx) as a PDF document and Word document.

A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AUASB website: www.auasb.gov.au

Contact Details

Auditing and Assurance Standards Board
Podium Level 14, 530 Collins Street
Melbourne Victoria 3000
AUSTRALIA

Phone: (03) 8080 7400
E-mail: enquiries@auasb.gov.au

Postal Address:
PO Box 204, Collins Street West
Melbourne Victoria 8007
AUSTRALIA

COPYRIGHT

© 2018 Auditing and Assurance Standards Board (AUASB). The text, graphics and layout of this Exposure Draft are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source as being the AUASB.

Requests and enquiries concerning reproduction and rights for commercial purposes within Australia should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Otherwise, no part of this Exposure Draft may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

This Exposure Draft reproduces substantial parts of the corresponding International Standard on Auditing issued by the International Auditing and Assurance Standards Board (IAASB) and published by the International Federation of Accountants (IFAC), in the manner described in the statement on Conformity with International Standards on Auditing. The AUASB acknowledges that IFAC is the owner of copyright in the International Standard on Auditing incorporated in this Exposure Draft throughout the world.

All existing rights in this material are reserved outside Australia. Reproduction outside Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use only.

Further information and requests for authorisation to reproduce this Exposure Draft for commercial purposes outside Australia should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Any decision to approve a request may also require the agreement of IFAC.

ISSN 1030-603X

CONTENTS

PREFACE

AUTHORITY STATEMENT

CONFORMITY WITH INTERNATIONAL STANDARDS ON AUDITING

Paragraphs

Application	Aus 0.1-Aus 0.2
Operative Date	Aus 0.3
Introduction	
Scope of this Auditing Standard	1
Nature of Accounting Estimates	2-3
Key Concepts of this Auditing Standard	4-9
Effective Date	10
Objective	11
Definitions	12
Requirements	
Risk Assessment Procedures and Related Activities	13-15
Identifying and Assessing the Risks of Material Misstatement	16-17
Responses to the Assessed Risks of Material Misstatement	18-30
Disclosures Related to Accounting Estimates	31
Indicators of Possible Management Bias	32
Overall Evaluation Based on Audit Procedures Performed	33-36
Written Representations	37
Communication with Those Charged With Governance, Management, or Other Relevant Parties	38
Documentation	39
Application and Other Explanatory Material	
Nature of Accounting Estimates	A1-A7
Key Concepts of this Auditing Standard	A8-A13
Definitions	A14-A18
Risk Assessment Procedures and Related Activities	A19-A63
Identifying and Assessing the Risks of Material Misstatement	A64-A80
Responses to the Assessed Risks of Material Misstatement	A81-A132
Indicators of Possible Management Bias	A133-A136
Overall Evaluation Based on Audit Procedures Performed	A137-A144
Written Representations	A145

Proposed Auditing Standard ASA 540
Auditing Accounting Estimates and Related Disclosures

Communication with Those Charged With Governance, Management or Other Relevant Parties.....	A146-A148
Documentation	A149-A152

Appendix 1: Inherent Risk Factors

Appendix 2: Communications with Those Charged with Governance

PREFACE

Reasons for Issuing ED 03/18

The AUASB issues exposure draft ED 03/18 of Proposed Auditing Standard ASA 540 *Auditing Accounting Estimates and Related Disclosures* pursuant to the requirements of the legislative provisions and the Strategic Direction explained below.

The AUASB is a non corporate Commonwealth entity of the Australian Government established under section 227A of the *Australian Securities and Investments Commission Act 2001*, as amended (ASIC Act). Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislation Act 2003*.

Under the Strategic Direction given to the AUASB by the Financial Reporting Council (FRC), the AUASB is required, inter alia, to develop auditing standards that have a clear public interest focus and are of the highest quality. Under the Strategic Direction, the AUASB is required to have regard to any program initiated by the IAASB for the revision and enhancement of the International Standards on Auditing (ISAs) and to make appropriate consequential amendments to the Australian Auditing Standards.

Main Proposals

This proposed Auditing Standard represents the Australian equivalent of Revised ISA 540 *Auditing Accounting Estimates and Related Disclosures* approved by the IAASB in June 2018 and will replace the current ASA 540 issued by the AUASB in October 2009 (as amended).

This proposed Auditing Standard contains differences from the current ASA 540, as detailed in the Explanatory Memorandum Exposure draft 03/18: *Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures* and Exposure draft 04/18: *Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards* (Explanatory Memorandum).

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 15 December 2019.

Main changes from existing ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (October 2009) as amended

For the main differences between this proposed Auditing Standard and the Auditing Standard that it supersedes, ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (October 2009) as amended, refer to the Explanatory Memorandum.

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of ASA 540 *Auditing Accounting Estimates and Related Disclosures* by no later than 15 October 2018. The AUASB is seeking comments from respondents on the following questions:

1. Have applicable laws and regulations been appropriately addressed in the proposed standard? Are there any references to relevant laws or regulations that have been omitted?
2. Whether there are any laws or regulations that may, or do, prevent or impede the application of the proposed standards, or may conflict with the proposed standards?

Proposed Auditing Standard ASA 540
Auditing Accounting Estimates and Related Disclosures

3. What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the main changes to the requirements of the proposed standards? If significant costs are expected, the AUASB would like to understand:
 - (a) Where those costs are likely to occur;
 - (b) The estimated extent of costs, in percentage terms (relative to audit fee); and
 - (c) Whether expected costs outweigh the benefits to the users of audit services?
4. What, if any, implementation guidance auditors, preparers and other stakeholders would like the AUASB to issue in conjunction with the release of ASA 540 (specific questions/examples would be helpful).
5. Are there any other significant public interest matters that constituents wish to raise?

The AUASB prefers that respondents express a clear opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on the above matters. The AUASB regards both supportive and critical comments as essential to a balanced review of the proposed Auditing Standard.

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes this Auditing Standard ASA 540 *Auditing Accounting Estimates and Related Disclosures* pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001* and section 336 of the *Corporations Act 2001*.

This Auditing Standard is to be read in conjunction with ASA 101 *Preamble to Australian Auditing Standards*, which sets out the intentions of the AUASB on how the Australian Auditing Standards, operative for financial reporting periods commencing on or after 1 January 2010, are to be understood, interpreted and applied. This Auditing Standard is to be read also in conjunction with ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*.

Conformity with International Standards on Auditing

This Auditing Standard conforms with International Standard on Auditing ISA 540 *Auditing Accounting Estimates and Related Disclosures* issued by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board of the International Federation of Accountants (IFAC).

Paragraphs that have been added to this Auditing Standard (and do not appear in the text of the equivalent ISA) are identified with the prefix “Aus”.

This Auditing Standard incorporates terminology and definitions used in Australia.

The equivalent requirements and related application and other explanatory material included in ISA 540 in respect of “relevant ethical requirements”, have been included in Auditing Standard, ASA 102 *Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements*. There is no international equivalent to ASA 102.

Compliance with this Auditing Standard enables compliance with ISA 540.

AUDITING STANDARD ASA 540

Auditing Accounting Estimates and Related Disclosures

Application

- Aus 0.1 This Auditing Standard applies to:
- (a) an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with the *Corporations Act 2001*; and
 - (b) an audit of a financial report, or a complete set of financial statements, for any other purpose.
- Aus 0.2 This Auditing Standard also applies, as appropriate, to an audit of other historical financial information.

Operative Date

- Aus 0.3 This Auditing Standard is operative for financial reporting periods commencing on or after 15 December 2019.

Introduction

Scope of this Auditing Standard

1. This Auditing Standard deals with the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of a financial report. Specifically, it includes requirements and guidance that refer to, or expand on, how ASA 315,¹ ASA 330,² ASA 450,³ ASA 500⁴ and other relevant Auditing Standards are to be applied in relation to accounting estimates and related disclosures. It also includes requirements and guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias.

Nature of Accounting Estimates

2. Accounting estimates vary widely in nature and are required to be made by management when the monetary amounts cannot be directly observed. The measurement of these monetary amounts is subject to estimation uncertainty, which reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The process of making accounting estimates involves selecting and applying a method using assumptions and data, which requires judgement by management and can give rise to complexity in measurement. The effects of complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement. (Ref: Para. A1–A6, Appendix 1)
3. Although this Auditing Standard applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by this Auditing Standard will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature, and the complexity and subjectivity involved in making

¹ See ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

² See ASA 330 *The Auditor's Responses to Assessed Risks*.

³ See ASA 450 *Evaluation of Misstatements Identified during the Audit*.

⁴ See ASA 500 *Audit Evidence*.

them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required by this Auditing Standard would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive. This Auditing Standard contains guidance on how the requirements of this Auditing Standard can be scaled. (Ref: Para. A7)

Key Concepts of this Auditing Standard

4. This Auditing Standard requires a separate assessment of inherent risk for purposes of assessing the risks of material misstatement at the assertion level for accounting estimates. Depending on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, and the interrelationship among them. As explained in ASA 200,⁵ inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to in this Auditing Standard as the spectrum of inherent risk. (Ref: Para. A8–A9, A65–A66, Appendix 1)
5. This Auditing Standard refers to relevant requirements in ASA 315 and ASA 330, and provides related guidance, to emphasise the importance of the auditor's decisions about controls relating to accounting estimates, including decisions about whether:
 - There are controls relevant to the audit, for which the auditor is required to evaluate their design and determine whether they have been implemented.
 - To test the operating effectiveness of relevant controls.
6. This Auditing Standard also requires a separate assessment of control risk when assessing the risks of material misstatement at the assertion level for accounting estimates. In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls. If the auditor does not perform tests of controls, the auditor's assessment of the risk of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion.⁶ (Ref: Para. A10)
7. This Auditing Standard emphasises that the auditor's further audit procedures (including, where appropriate, tests of controls) need to be responsive to the reasons for the assessed risks of material misstatement at the assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk.
8. The exercise of professional scepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors. Similarly, the exercise of professional scepticism is important when there is greater susceptibility to misstatement due to management bias or fraud. (Ref: Para. A11)
9. This Auditing Standard requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable⁷ in the context of the applicable financial reporting framework, or are misstated. For purposes of this Auditing Standard, reasonable in the context of the applicable financial reporting framework means that the relevant requirements of the

⁵ See ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, paragraph A40.

⁶ See ASA 530 *Audit Sampling*, Appendix 3.

⁷ See also ASA 700 *Forming an Opinion and Reporting on a Financial report*, paragraph 13(c).

applicable financial reporting framework have been applied appropriately, including those that address: (Ref: Para. A12–A13, A139–A144)

- The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity;
- The selection of management’s point estimate; and
- The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

Effective Date

10. [Deleted by the AUASB. Refer Aus 0.3]

Objective

11. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial report are reasonable in the context of the applicable financial reporting framework.

Definitions

12. For the purposes of this Auditing Standard, the following terms have the meanings attributed below:
- (a) Accounting estimate – A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty. (Ref: Para. A14)
 - (b) Auditor’s point estimate or auditor’s range – An amount, or range of amounts, respectively, developed by the auditor in evaluating management’s point estimate. (Ref: Para. A15)
 - (c) Estimation uncertainty – Susceptibility to an inherent lack of precision in measurement. (Ref: Para. A16, Appendix 1)
 - (d) Management bias – A lack of neutrality by management in the preparation of information. (Ref: Para. A17)
 - (e) Management’s point estimate – The amount selected by management for recognition or disclosure in the financial report as an accounting estimate.
 - (f) Outcome of an accounting estimate – The actual monetary amount that results from the resolution of the transaction(s), event(s) or condition(s) addressed by an accounting estimate. (Ref: Para. A18)

Requirements

Risk Assessment Procedures and Related Activities

13. When obtaining an understanding of the entity and its environment, including the entity’s internal control, as required by ASA 315,⁸ the auditor shall obtain an understanding of the following matters related to the entity’s accounting estimates. The auditor’s procedures to

⁸ See ASA 315, paragraphs 3, 5–6, 9, 11–12, 15–17, and 20–21.

obtain the understanding shall be performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. (Ref: Para. A19–A22)

The Entity and Its Environment

- (a) The entity's transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognised or disclosed in the financial report. (Ref: Para. A23)
- (b) The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements); and how they apply in the context of the nature and circumstances of the entity and its environment, including how transactions and other events or conditions are subject to, or affected by, inherent risk factors. (Ref: Para. A24–A25)
- (c) Regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks related to prudential supervision. (Ref: Para. A26)
- (d) The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial report, based on the auditor's understanding of the matters in 13(a)–(c) above. (Ref: Para. A27)

The Entity's Internal Control

- (e) The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates. (Ref: Para. A28–A30).
- (f) How management identifies the need for, and applies, specialised skills or knowledge related to accounting estimates, including with respect to the use of a management's expert. (Ref: Para. A31)
- (g) How the entity's risk assessment process identifies and addresses risks relating to accounting estimates. (Ref: Para. A32–A33)
- (h) The entity's information system as it relates to accounting estimates, including:
 - (i) The classes of transactions, events and conditions, that are significant to the financial report and that give rise to the need for, or changes in, accounting estimates and related disclosures; and (Ref: Para. A34–A35)
 - (ii) For such accounting estimates and related disclosures, how management:
 - a Identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management: (Ref: Para. A36–A37)
 - a. Selects or designs, and applies, the methods used, including the use of models; (Ref: Para. A38–A39)
 - b. Selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions; (Ref: Para. A40–A43); and
 - c. Selects the data to be used; (Ref: Para. A44)

2. Understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes; and (Ref: Para. A45)
 3. Addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial report. (Ref: Para. A46–A49)
- (i) Control activities relevant to the audit over management’s process for making accounting estimates as described in paragraph 13(h)(ii). (Ref: Para. A50–A54)
 - (j) How management reviews the outcome(s) of previous accounting estimates and responds to the results of that review.
14. The auditor shall review the outcome of previous accounting estimates, or, where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor shall take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgements about previous period accounting estimates that were appropriate based on the information available at the time they were made. (Ref: Para. A55–A60)
15. With respect to accounting estimates, the auditor shall determine whether the engagement team requires specialised skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained. (Ref: Para. A61–A63)

Identifying and Assessing the Risks of Material Misstatement

16. In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level, as required by ASA 315,⁹ the auditor shall separately assess inherent risk and control risk. The auditor shall take the following into account in identifying the risks of material misstatement and in assessing inherent risk: (Ref: Para. A64–A71)
- (a) The degree to which the accounting estimate is subject to estimation uncertainty; and (Ref: Para. A72–A75)
 - (b) The degree to which the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: Para. A76–A79)
 - (i) The selection and application of the method, assumptions and data in making the accounting estimate; or
 - (ii) The selection of management’s point estimate and related disclosures for inclusion in the financial report.
17. The auditor shall determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 16 are, in the auditor’s judgement, a significant risk.¹⁰ If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity’s controls, including control activities, relevant to that risk.¹¹ (Ref: Para. A80)

⁹ See ASA 315, paragraph 25 and 26.

¹⁰ See ASA 315, paragraph 27.

¹¹ See ASA 315, paragraph 29.

Responses to the Assessed Risks of Material Misstatement

18. As required by ASA 330,¹² the auditor's further audit procedures shall be responsive to the assessed risks of material misstatement at the assertion level,¹³ considering the reasons for the assessment given to those risks. The auditor's further audit procedures shall include one or more of the following approaches:

- (a) Obtaining audit evidence from events occurring up to the date of the auditor's report (see paragraph 21);
- (b) Testing how management made the accounting estimate (see paragraphs 22–27); or
- (c) Developing an auditor's point estimate or range (see paragraphs 28–29).

The auditor's further audit procedures shall take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be.¹⁴ The auditor shall design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. (Ref: Para. A81–A84)

19. As required by ASA 330,¹⁵ the auditor shall design and perform tests to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls, if:

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively, or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In relation to accounting estimates, the auditor's tests of such controls shall be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.¹⁶ (Ref: Para. A85–A89)

20. For a significant risk relating to an accounting estimate, the auditor's further audit procedures shall include tests of controls in the current period if the auditor plans to rely on those controls. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.¹⁷ (Ref: Para. A90)

Obtaining Audit Evidence from Events Occurring up to the Date of the Auditor's Report

21. When the auditor's further audit procedures include obtaining audit evidence from events occurring up to the date of the auditor's report, the auditor shall evaluate whether such audit evidence is sufficient and appropriate to address the risks of material misstatement relating to the accounting estimate, taking into account that changes in circumstances and other relevant conditions between the event and the measurement date may affect the relevance of such audit evidence in the context of the applicable financial reporting framework. (Ref: Para. A91–A93)

Testing How Management Made the Accounting Estimate

22. When testing how management made the accounting estimate, the auditor's further audit procedures shall include procedures, designed and performed in accordance with paragraphs

¹² See ASA 330, paragraphs 6–15 and 18.

¹³ See ASA 330, paragraphs 6–7 and 21.

¹⁴ See ASA 330, paragraph 7(b).

¹⁵ See ASA 330, paragraph 8.

¹⁶ See ASA 330, paragraph 9.

¹⁷ See ASA 330, paragraphs 15 and 21.

23–26, to obtain sufficient appropriate audit evidence regarding the risks of material misstatement relating to: (Ref: Para. A94)

- (a) The selection and application of the methods, significant assumptions and the data used by management in making the accounting estimate; and
- (b) How management selected the point estimate and developed related disclosures about estimation uncertainty.

Methods

23. In applying the requirements of paragraph 22, with respect to methods, the auditor's further audit procedures shall address:
- (a) Whether the method selected is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from the method used in prior periods are appropriate; (Ref: Para. A95, A97)
 - (b) Whether judgements made in selecting the method give rise to indicators of possible management bias; (Ref: Para. A96)
 - (c) Whether the calculations are applied in accordance with the method and are mathematically accurate;
 - (d) When management's application of the method involves complex modelling, whether judgements have been applied consistently and whether, when applicable: (Ref: Para. A98–A100)
 - (i) The design of the model meets the measurement objective of the applicable financial reporting framework, is appropriate in the circumstances, and, if applicable, changes from the prior period's model are appropriate in the circumstances; and
 - (ii) Adjustments to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances; and
 - (e) Whether the integrity of the significant assumptions and the data has been maintained in applying the method. (Ref: Para. A101)

Significant Assumptions

24. In applying the requirements of paragraph 22, with respect to significant assumptions, the auditor's further audit procedures shall address:
- (a) Whether the significant assumptions are appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate; (Ref: Para. A95, A102–A103)
 - (b) Whether judgements made in selecting the significant assumptions give rise to indicators of possible management bias; (Ref: Para. A96)
 - (c) Whether the significant assumptions are consistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit; and (Ref: Para. A104)
 - (d) When applicable, whether management has the intent to carry out specific courses of action and has the ability to do so. (Ref: Para. A105)

Data

25. In applying the requirements of paragraph 22, with respect to data, the auditor's further audit procedures shall address:
- (a) Whether the data is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate; (Ref: Para. A95, A106)
 - (b) Whether judgements made in selecting the data give rise to indicators of possible management bias; (Ref: Para. A96)
 - (c) Whether the data is relevant and reliable in the circumstances; and (Ref: Para. A107)
 - (d) Whether the data has been appropriately understood or interpreted by management, including with respect to contractual terms. (Ref: Para. A108)

Management's Selection of a Point Estimate and Related Disclosures about Estimation Uncertainty

26. In applying the requirements of paragraph 22, the auditor's further audit procedures shall address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to:
- (a) Understand estimation uncertainty; and (Ref: Para. A109)
 - (b) Address estimation uncertainty by selecting an appropriate point estimate and by developing related disclosures about estimation uncertainty. (Ref: Para. A110–A114)
27. When, in the auditor's judgement based on the audit evidence obtained, management has not taken appropriate steps to understand or address estimation uncertainty, the auditor shall: (Ref: Para. A115–A117)
- (a) Request management to perform additional procedures to understand estimation uncertainty or to address it by reconsidering the selection of management's point estimate or considering providing additional disclosures relating to the estimation uncertainty, and evaluate management's response(s) in accordance with paragraph 26;
 - (b) If the auditor determines that management's response to the auditor's request does not sufficiently address estimation uncertainty, to the extent practicable, develop an auditor's point estimate or range in accordance with paragraphs 28–29; and
 - (c) Evaluate whether a deficiency in internal control exists and, if so, communicate in accordance with ASA 265.¹⁸

Developing an Auditor's Point Estimate or Range

28. When the auditor develops a point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty, including when required by paragraph 27(b), the auditor's further audit procedures shall include procedures to evaluate whether the methods, assumptions or data used are appropriate in the context of the applicable financial reporting framework. Regardless of whether the auditor uses management's or the auditor's own methods, assumptions or data, these further audit procedures shall be designed and performed to address the matters in paragraphs 23–25. (Ref: Para. A118–A123)
29. If the auditor develops an auditor's range, the auditor shall:

¹⁸ See ASA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*.

- (a) Determine that the range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated by the auditor to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework; and (Ref: Para. A124–A125)
- (b) Design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement relating to the disclosures in the financial report that describe the estimation uncertainty.

Other Considerations Relating to Audit Evidence

30. In obtaining audit evidence regarding the risks of material misstatement relating to accounting estimates, irrespective of the sources of information to be used as audit evidence, the auditor shall comply with the relevant requirements in ASA 500.

When using the work of a management's expert, the requirements in paragraphs 21–29 of this Auditing Standard may assist the auditor in evaluating the appropriateness of the expert's work as audit evidence for a relevant assertion in accordance with paragraph 8(c) of ASA 500. In evaluating the work of the management's expert, the nature, timing and extent of the further audit procedures are affected by the auditor's evaluation of the expert's competence, capabilities and objectivity, the auditor's understanding of the nature of the work performed by the expert, and the auditor's familiarity with the expert's field of expertise. (Ref: Para. A126–A132)

Disclosures Related to Accounting Estimates

31. The auditor shall design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level for disclosures related to an accounting estimate, other than those related to estimation uncertainty addressed in paragraphs 26(b) and 29(b).

Indicators of Possible Management Bias

32. The auditor shall evaluate whether judgements and decisions made by management in making the accounting estimates included in the financial report, even if they are individually reasonable, are indicators of possible management bias. When indicators of possible management bias are identified, the auditor shall evaluate the implications for the audit. Where there is intention to mislead, management bias is fraudulent in nature. (Ref: Para. A133–A136)

Overall Evaluation Based on Audit Procedures Performed

33. In applying ASA 330 to accounting estimates,¹⁹ the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A137–A138)
- (a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified;
 - (b) Management's decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates in the financial report are in accordance with the applicable financial reporting framework; and
 - (c) Sufficient appropriate audit evidence has been obtained.

¹⁹ See ASA 330, paragraphs 25–26.

34. In making the evaluation required by paragraph 33(c), the auditor shall take into account all relevant audit evidence obtained, whether corroborative or contradictory.²⁰ If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall evaluate the implications for the audit or the auditor's opinion on the financial report in accordance with ASA 705.²¹

Determining Whether the Accounting Estimates are Reasonable or Misstated

35. The auditor shall determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. ASA 450²² provides guidance on how the auditor may distinguish misstatements (whether factual, judgemental, or projected) for the auditor's evaluation of the effect of uncorrected misstatements on the financial report. (Ref: Para. A12–A13, A139–A144)
36. In relation to accounting estimates, the auditor shall evaluate:
- (a) In the case of a fair presentation framework, whether management has included disclosures, beyond those specifically required by the framework, that are necessary to achieve the fair presentation of the financial report as a whole;²³ or
 - (b) In the case of a compliance framework, whether the disclosures are those that are necessary for the financial report not to be misleading.²⁴

Written Representations

37. The auditor shall request written representations from management²⁵ and, when appropriate, those charged with governance about whether the methods, significant assumptions and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement or disclosure that is in accordance with the applicable financial reporting framework. The auditor shall also consider the need to obtain representations about specific accounting estimates, including in relation to the methods, assumptions, or data used. (Ref: Para. A145)

Communication with Those Charged With Governance, Management, or Other Relevant Parties

38. In applying ASA 260²⁶ and ASA 265,²⁷ the auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control, respectively. In doing so, the auditor shall consider the matters, if any, to communicate regarding accounting estimates and take into account whether the reasons given to the risks of material misstatement relate to estimation uncertainty, or the effects of complexity, subjectivity or other inherent risk factors in making accounting estimates and related disclosures. In addition, in certain circumstances, the auditor is required by law or regulation to communicate about certain matters with other relevant parties, such as regulators or prudential supervisors. (Ref: Para. A146–A148)

²⁰ See ASA 500, paragraph 11.

²¹ See ASA 705 *Modifications to the Opinion in the Independent Auditor's Report*.

²² See ASA 450, paragraph A6.

²³ See also ASA 700 *Forming an Opinion and Reporting on a Financial Report*, paragraph 14.

²⁴ See also ASA 700 *Forming an Opinion and Reporting on a Financial Report*, paragraph 19.

²⁵ See ASA 580 *Written Representations*.

²⁶ See ASA 260 *Communication with Those Charged with Governance*, paragraph 16(a).

²⁷ See ASA 265, paragraph 9.

Documentation

39. The auditor shall include in the audit documentation:²⁸ (Ref: Para. A149–A152)
- (a) Key elements of the auditor’s understanding of the entity and its environment, including the entity’s internal control related to the entity’s accounting estimates;
 - (b) The linkage of the auditor’s further audit procedures with the assessed risks of material misstatement at the assertion level,²⁹ taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks;
 - (c) The auditor’s response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;
 - (d) Indicators of possible management bias related to accounting estimates, if any, and the auditor’s evaluation of the implications for the audit, as required by paragraph 32; and
 - (e) Significant judgements relating to the auditor’s determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

* * *

²⁸ See ASA 230 *Audit Documentation*, paragraphs 8–11, A6, A7 and A10.

²⁹ See ASA 330, paragraph 28(b).

Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

Examples of Accounting Estimates

- A1. Examples of accounting estimates related to classes of transactions, account balances and disclosures include:
- Inventory obsolescence.
 - Depreciation of property and equipment.
 - Valuation of infrastructure assets.
 - Valuation of financial instruments.
 - Outcome of pending litigation.
 - Provision for expected credit losses.
 - Valuation of insurance contract liabilities.
 - Warranty obligations.
 - Employee retirement benefits liabilities.
 - Share-based payments.
 - Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets.
 - Impairment of long-lived assets or property or equipment held for disposal.
 - Non-monetary exchanges of assets or liabilities between independent parties.
 - Revenue recognised for long-term contracts.

Methods

- A2. A method is a measurement technique used by management to make an accounting estimate in accordance with the required measurement basis. For example, one recognised method used to make accounting estimates relating to share-based payment transactions is to determine a theoretical option call price using the Black Scholes option pricing formula. A method is applied using a computational tool or process, sometimes referred to as a model, and involves applying assumptions and data and taking into account a set of relationships between them.

Assumptions and Data

- A3. Assumptions involve judgements based on available information about matters such as the choice of an interest rate, a discount rate, or judgements about future conditions or events. An assumption may be selected by management from a range of appropriate alternatives. Assumptions that may be made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate.
- A4. For purposes of this Auditing Standard, data is information that can be obtained through direct observation or from a party external to the entity. Information obtained by applying analytical or interpretive techniques to data is referred to as derived data when such techniques have a well-established theoretical basis and therefore less need for management judgement. Otherwise, such information is an assumption.

A5. Examples of data include:

- Prices agreed in market transactions;
- Operating times or quantities of output from a production machine;
- Historical prices or other terms included in contracts, such as a contracted interest rate, a payment schedule, and term included in a loan agreement;
- Forward-looking information such as economic or earnings forecasts obtained from an external information source, or
- A future interest rate determined using interpolation techniques from forward interest rates (derived data).

A6. Data can come from a wide range of sources. For example, data can be:

- Generated within the organisation or externally;
- Obtained from a system that is either within or outside the general or subsidiary ledgers;
- Observable in contracts; or
- Observable in legislative or regulatory pronouncements.

Scalability (Ref: Para. 3)

A7. Examples of paragraphs that include guidance on how the requirements of this Auditing Standard can be scaled include paragraphs A20–A22, A63, A67, and A84.

Key Concepts of this Auditing Standard

Inherent Risk Factors (Ref: Para. 4)

- A8. Inherent risk factors are characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement, before consideration of controls. Appendix 1 further explains the nature of these inherent risk factors, and their inter-relationships, in the context of making accounting estimates and their presentation in the financial report.
- A9. In addition to the inherent risk factors of estimation uncertainty, complexity or subjectivity, other inherent risk factors that the auditor may consider in identifying and assessing the risks of material misstatement may include the extent to which the accounting estimate is subject to, or affected by:
- Change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework which may give rise to the need for changes in the method, assumptions or data used to make the accounting estimate.
 - Susceptibility to misstatement due to management bias or fraud in making the accounting estimate.

Control Risk (Ref: Para. 6)

A10. An important consideration for the auditor in assessing control risk at the assertion level is the effectiveness of the design of the controls that the auditor intends to rely on and the extent to which the controls address the assessed inherent risks at the assertion level. The auditor's evaluation that controls are effectively designed and have been implemented supports an

expectation about the operating effectiveness of the controls in determining whether to test them.

Professional Scepticism (Ref: Para. 8)

- A11. Paragraphs A60, A95, A96, A137 and A139 are examples of paragraphs that describe ways in which the auditor can exercise professional scepticism. Paragraph A152 provides guidance on ways in which the auditor's exercise of professional scepticism may be documented, and includes examples of specific paragraphs in this Auditing Standard for which documentation may provide evidence of the exercise of professional scepticism.

Concept of "Reasonable" (Ref: Para. 9, 35)

- A12. Other considerations that may be relevant to the auditor's consideration of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework include whether:
- The data and assumptions used in making the accounting estimate are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities; and
 - The accounting estimate takes into account appropriate information as required by the applicable financial reporting framework.
- A13. The term "applied appropriately" as used in paragraph 9 means in a manner that not only complies with the requirements of the applicable financial reporting framework but, in doing so, reflects judgements that are consistent with the objective of the measurement basis in that framework.

Definitions

Accounting Estimate (Ref: Para. 12(a))

- A14. Accounting estimates are monetary amounts that may be related to classes of transactions or account balances recognised or disclosed in the financial report. Accounting estimates also include monetary amounts included in disclosures or used to make judgements about recognition or disclosure relating to a class of transactions or account balance.

Auditor's Point Estimate or Auditor's Range (Ref: Para. 12(b))

- A15. An auditor's point estimate or range may be used to evaluate an accounting estimate directly (for example, an impairment provision or the fair value of different types of financial instruments), or indirectly (for example, an amount to be used as a significant assumption for an accounting estimate). A similar approach may be taken by the auditor in developing an amount or range of amounts in evaluating a non-monetary item of data or an assumption (for example, an estimated useful life of an asset).

Estimation Uncertainty (Ref: Para. 12(c))

- A16. Not all accounting estimates are subject to a high degree of estimation uncertainty. For example, some financial statement items may have an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

Management Bias (Ref: Para. 12(d))

- A17. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Estimation uncertainty gives rise to subjectivity in making an accounting estimate. The presence of subjectivity gives rise to the need for judgement by management and the susceptibility to unintentional or intentional management bias (for example, as a result of motivation to achieve a desired profit target or capital ratio). The susceptibility of an accounting estimate to management bias increases with the extent to which there is subjectivity in making the accounting estimate.

Outcome of an Accounting Estimate (Ref: Para. 12(f))

- A18. Some accounting estimates, by their nature, do not have an outcome that is relevant for the auditor's work performed in accordance with this Auditing Standard. For example, an accounting estimate may be based on perceptions of market participants at a point in time. Accordingly, the price realised when an asset is sold or a liability is transferred may differ from the related accounting estimate made at the reporting date because, with the passage of time, the market participants' perceptions of value have changed.

Risk Assessment Procedures and Related Activities

Obtaining an Understanding of the Entity and Its Environment (Ref: Para. 13)

- A19. Paragraphs 11–24 of ASA 315 require the auditor to obtain an understanding of certain matters about the entity and its environment, including the entity's internal control. The requirements in paragraph 13 of this Auditing Standard relate more specifically to accounting estimates and build on the broader requirements in ASA 315.

Scalability

- A20. The nature, timing, and extent of the auditor's procedures to obtain the understanding of the entity and its environment, including the entity's internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matter(s) apply in the circumstances. For example, the entity may have few transactions or other events and conditions that give rise to the need for accounting estimates, the applicable financial reporting requirements may be simple to apply, and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgements, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree and there may be fewer controls relevant to the audit. If so, the auditor's risk assessment procedures are likely to be less extensive and may be obtained primarily through enquiries of management with appropriate responsibilities for the financial report and simple walk-throughs of management's process for making the accounting estimate.
- A21. By contrast, the accounting estimates may require significant judgements by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system, and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor's risk assessment procedures are likely to be different, or be more extensive, than in the circumstances in paragraph A20.
- A22. The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities:

- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.
- Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

The Entity and Its Environment

The entity's transactions and other events and conditions (Ref: Para. 13(a))

A23. Changes in circumstances that may give rise to the need for, or changes in, accounting estimates may include, for example, whether:

- The entity has engaged in new types of transactions;
- Terms of transactions have changed; or
- New events or conditions have occurred.

The requirements of the applicable financial reporting framework (Ref: Para. 13(b))

A24. Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and, where applicable, those charged with governance about how management has applied those requirements relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework, not to be the most appropriate in the circumstances of the entity.³⁰

A25. In obtaining this understanding, the auditor may seek to understand whether:

- The applicable financial reporting framework:
 - Prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates;
 - Specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability; or
 - Specifies required or suggested disclosures, including disclosures concerning judgements, assumptions, or other sources of estimation uncertainty relating to accounting estimates; and
- Changes in the applicable financial reporting framework require changes to the entity's accounting policies relating to accounting estimates.

Regulatory factors (Ref: Para. 13(c))

A26. Obtaining an understanding of regulatory factors, if any, that are relevant to accounting estimates may assist the auditor in identifying applicable regulatory frameworks (for example,

³⁰ See ASA 260, paragraph 16(a).

regulatory frameworks established by prudential supervisors in the banking or insurance industries) and in determining whether such regulatory framework(s):

- Addresses conditions for the recognition, or methods for the measurement, of accounting estimates, or provides related guidance thereon;
- Specifies, or provides guidance about, disclosures in addition to the requirements of the applicable financial reporting framework;
- Provides an indication of areas for which there may be a potential for management bias to meet regulatory requirements; or
- Contains requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting framework, which may indicate potential risks of material misstatement. For example, some regulators may seek to influence minimum levels for expected credit loss provisions that exceed those required by the applicable financial reporting framework.

The nature of the accounting estimates and related disclosures that the auditor expects to be included in the financial report (Ref: Para. 13(d))

- A27. Obtaining an understanding of the nature of accounting estimates and related disclosures that the auditor expects to be included in the entity's financial report assists the auditor in understanding the measurement basis of such accounting estimates and the nature and extent of disclosures that may be relevant. Such an understanding provides the auditor with a basis for discussion with management about how management makes the accounting estimates.

The Entity's Internal Control Relevant to the Audit

The nature and extent of oversight and governance (Ref: Para. 13(e))

- A28. In applying ASA 315,³¹ the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for making accounting estimates may be important to the auditor's required evaluation as it relates to whether:
- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour; and
 - The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are undermined by deficiencies in the control environment.
- A29. The auditor may obtain an understanding of whether those charged with governance:
- Have the skills or knowledge to understand the characteristics of a particular method or model to make accounting estimates, or the risks related to the accounting estimate, for example, risks related to the method or information technology used in making the accounting estimates;
 - Have the skills and knowledge to understand whether management made the accounting estimates in accordance with the applicable financial reporting framework;
 - Are independent from management, have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to call into question management's actions when those actions appear to be inadequate or inappropriate;

³¹ See ASA 315, paragraph 14.

- Oversee management's process for making the accounting estimates, including the use of models; or
- Oversee the monitoring activities undertaken by management. This may include supervision and review procedures designed to detect and correct any deficiencies in the design or operating effectiveness of controls over the accounting estimates.

A30. Obtaining an understanding of the oversight by those charged with governance may be important when there are accounting estimates that:

- Require significant judgement by management to address subjectivity;
- Have high estimation uncertainty;
- Are complex to make, for example, because of the extensive use of information technology, large volumes of data or the use of multiple data sources or assumptions with complex-interrelationships;
- Had, or ought to have had, a change in the method, assumptions or data compared to previous periods; or
- Involve significant assumptions.

Management's application of specialised skills or knowledge, including the use of management's experts (Ref: Para. 13(f))

A31. The auditor may consider whether the following circumstances increase the likelihood that management needs to engage an expert:³²

- The specialised nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms.
- The complex nature of the models required to apply the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements, such as level 3 fair values.³³
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

The entity's risk assessment process (Ref: Para. 13(g))

A32. Understanding how the entity's risk assessment process identifies and addresses risks relating to accounting estimates may assist the auditor in considering changes in:

- The requirements of the applicable financial reporting framework related to the accounting estimates;
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used;
- The entity's information system or IT environment; and

³² See ASA 500, paragraph 8.

³³ See, for example, Accounting Standard AASB 13 *Fair Value Measurement*.

- Key personnel.
- A33. Matters that the auditor may consider in obtaining an understanding of how management identified and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether, and if so how, management:
- Pays particular attention to selecting or applying the methods, assumptions and data used in making accounting estimates.
 - Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors.
 - Identifies financial or other incentives that may be a motivation for bias.
 - Monitors the need for changes in the methods, significant assumptions or the data used in making accounting estimates.
 - Establishes appropriate oversight and review of models used in making accounting estimates.
 - Requires documentation of the rationale for, or an independent review of, significant judgements made in making accounting estimates.

The entity's information system relating to accounting estimates (Ref: Para. 13(h)(i))

- A34. The classes of transactions, events and conditions within the scope of paragraph 13(h) are the same as the classes of transactions, events and conditions relating to accounting estimates and related disclosures that are subject to paragraphs 18(a) and (d) of ASA 315. In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider:
- Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions.
 - How the information system addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities.
- A35. During the audit, the auditor may identify classes of transactions, events and conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. ASA 315 deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment process.³⁴

Management's Identification of the Relevant Methods, Assumptions and Sources of Data
(Ref: Para. 13(h)(ii)(a))

- A36. If management has changed the method for making an accounting estimate, considerations may include whether the new method is, for example, more appropriate, is itself a response to changes in the environment or circumstances affecting the entity, or to changes in the requirements of the applicable financial reporting framework or regulatory environment, or whether management has another valid reason.
- A37. If management has not changed the method for making an accounting estimate, considerations may include whether the continued use of the previous methods, assumptions and data is appropriate in view of the current environment or circumstances.

³¹ See ASA 315, paragraph 17.

Methods (Ref: Para. 13(h)(ii)(a)(i))

- A38. The applicable financial reporting framework may prescribe the method to be used in making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method, or the required measurement basis prescribes, or allows, the use of alternative methods.

Models

- A39. Management may design and implement specific controls around models used for making accounting estimates, whether management's own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified as relevant to the audit. When complexity in relation to models is present, controls over data integrity are also more likely to be relevant to the audit. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and of control activities relevant to the audit include the following:

- How management determines the relevance and accuracy of the model;
- The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of:
 - The model's theoretical soundness;
 - The model's mathematical integrity; and
 - The accuracy and completeness of the data and the appropriateness of data and assumptions used in the model.
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;
- Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias; and
- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output.

Assumptions (Ref: Para. 13(h)(ii)(a)(ii))

- A40. Matters that the auditor may consider in obtaining an understanding of how management selected the assumptions used in making the accounting estimates include, for example:
- The basis for management's selection and the documentation supporting the selection of the assumption. The applicable financial reporting framework may provide criteria or guidance to be used in the selection of an assumption.
 - How management assesses whether the assumptions are relevant and complete.

- When applicable, how management determines that the assumptions are consistent with each other, with those used in other accounting estimates or areas of the entity's business activities, or with other matters that are:
 - Within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and whether they are consistent with the entity's business plans and the external environment; and
 - Outside the control of management (for example, assumptions about interest rates, mortality rates or potential judicial or regulatory actions).
- The requirements of the applicable financial reporting framework related to the disclosure of assumptions.

A41. With respect to fair value accounting estimates, assumptions vary in terms of the sources of the data and the basis for the judgements to support them, as follows:

- (a) Those that reflect what marketplace participants would use in pricing an asset or liability, developed based on market data obtained from sources independent of the reporting entity.
- (b) Those that reflect the entity's own judgements about what assumptions marketplace participants would use in pricing the asset or liability, developed based on the best data available in the circumstances.

In practice, however, the distinction between (a) and (b) may not always be apparent and distinguishing between them depends on understanding the sources of data and the basis for the judgements that support the assumption. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A42. Assumptions used in making an accounting estimate are referred to as significant assumptions in this Auditing Standard if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate. A sensitivity analysis may be useful in demonstrating the degree to which the measurement varies based on one or more assumptions used in making the accounting estimate.

Inactive or illiquid markets

A43. When markets are inactive or illiquid, the auditor's understanding of how management selects assumptions may include understanding whether management has:

- Implemented appropriate policies for adapting the application of the method in such circumstances. Such adaptation may include making model adjustments or developing new models that are appropriate in the circumstances;
- Resources with the necessary skills or knowledge to adapt or develop a model, if necessary on an urgent basis, including selecting the valuation technique that is appropriate in such circumstances;
- The resources to determine the range of outcomes, given the uncertainties involved, for example by performing a sensitivity analysis;
- The means to assess how, when applicable, the deterioration in market conditions has affected the entity's operations, environment and relevant business risks and the implications for the entity's accounting estimates, in such circumstances; and
- An appropriate understanding of how the price data, and the relevance thereof, from particular external information sources may vary in such circumstances.

Data (Ref: Para. 13(h)(ii)(a)(iii))

- A44. Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include:
- The nature and source of the data, including information obtained from an external information source.
 - How management evaluates whether the data is appropriate.
 - The accuracy and completeness of the data.
 - The consistency of the data used with data used in previous periods.
 - The complexity of the information technology systems used to obtain and process the data, including when this involves handling large volumes of data.
 - How the data is obtained, transmitted and processed and how its integrity is maintained.

How management understands and addresses estimation uncertainty (Ref: Para. 13(h)(ii)(b)–13(h)(ii)(c))

- A45. Matters that may be appropriate for the auditor to consider relating to whether and how management understands the degree of estimation uncertainty include, for example:
- Whether, and if so, how management identified alternative methods, significant assumptions or sources of data that are appropriate in the context of the applicable financial reporting framework.
 - Whether, and if so, how management considered alternative outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the significant assumptions or the data used in making the accounting estimate.
- A46. The requirements of the applicable financial reporting framework may specify the approach to selecting management's point estimate from the reasonably possible measurement outcomes. Financial reporting frameworks may recognise that the appropriate amount is one that is appropriately selected from the reasonably possible measurement outcomes and, in some cases, may indicate that the most relevant amount may be in the central part of that range.
- A47. For example, with respect to fair value estimates, AASB 13³⁵ indicates that, if multiple valuation techniques are used to measure fair value, the results (i.e., respective indications of fair value) shall be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances. In other cases, the applicable financial reporting framework may specify the use of a probability-weighted average of the reasonably possible measurement outcomes, or of the measurement amount that is most likely or that is more likely than not.
- A48. The applicable financial reporting framework may prescribe disclosures or disclosure objectives related to accounting estimates, and some entities may choose to disclose additional information. These disclosures or disclosure objectives may address, for example:
- The method of estimation used, including any applicable model and the basis for its selection.
 - Information that has been obtained from models, or from other calculations used to determine estimates recognised or disclosed in the financial report, including

³⁵ See Accounting Standard AASB 13 *Fair Value Measurement*, paragraph 63.

information relating to the underlying data and assumptions used in those models, such as:

- Assumptions developed internally; or
- Data, such as interest rates, that are affected by factors outside the control of the entity.
- The effect of any changes to the method of estimation from the prior period.
- The sources of estimation uncertainty.
- Fair value information.
- Information about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.

A49. In some cases, the applicable financial reporting framework may require specific disclosures regarding estimation uncertainty, for example:

- The disclosure of information about the assumptions made about the future and other major sources of estimation uncertainty that give rise to a higher likelihood or magnitude of material adjustment to the carrying amounts of assets and liabilities after the period end. Such requirements may be described using terms such as “Key Sources of Estimation Uncertainty” or “Critical Accounting Estimates.” They may relate to accounting estimates that require management’s most difficult, subjective or complex judgements. Such judgements may be more subjective and complex, and accordingly the potential for a consequential material adjustment to the carrying amounts of assets and liabilities may increase, with the number of items of data and assumptions affecting the possible future resolution of the estimation uncertainty. Information that may be disclosed includes:
 - The nature of the assumption or other source of estimation uncertainty;
 - The sensitivity of carrying amounts to the methods and assumptions used, including the reasons for the sensitivity;
 - The expected resolution of an uncertainty and the range of reasonably possible outcomes in respect of the carrying amounts of the assets and liabilities affected; and
 - An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of specific information, such as:
 - Information regarding the significance of fair value accounting estimates to the entity’s financial position and performance; and
 - Disclosures regarding market inactivity or illiquidity.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity’s objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.

- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

Control Activities Relevant to the Audit Over Management's Process for Making Accounting Estimates (Ref: Para 13(i))

- A50. The auditor's judgement in identifying controls relevant to the audit, and therefore the need to evaluate the design of those controls and determine whether they have been implemented, relates to management's process described in paragraph 13(h)(ii). The auditor may not identify relevant control activities in relation to all the elements of paragraph 13(h)(ii), depending on the complexity associated with the accounting estimate.
- A51. As part of obtaining an understanding of the control activities relevant to the audit, the auditor may consider:
- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
 - The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
 - The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.
 - The effectiveness of the design of the control activities. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements, than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for, and the nature of, the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.
- A52. When management makes extensive use of information technology in making an accounting estimate, controls relevant to the audit are likely to include general IT controls and application controls. Such controls may address risks related to:
- Whether the information technology system has the capability and is appropriately configured to process large volumes of data;
 - Complex calculations in applying a method. When diverse systems are required to process complex transactions, regular reconciliations between the systems are made, in particular when the systems do not have automated interfaces or may be subject to manual intervention;
 - Whether the design and calibration of models is periodically evaluated;
 - The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources;

- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting estimates, the maintenance of the integrity and security of the data. When using external information sources, risks related to processing or recording the data;
 - Whether management has controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorised access or amendments to those models; and
 - Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.
- A53. In some industries, such as banking or insurance, the term governance may be used to describe activities within the control environment, monitoring of controls, and other components of internal control, as described in ASA 315.³⁶
- A54. For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of:
- The nature and extent of management's use of accounting estimates;
 - The design and implementation of control activities that address the risks related to the data, assumptions and models used to make the accounting estimates;
 - The aspects of the entity's information system that generate the data on which the accounting estimates are based; and
 - How new risks relating to accounting estimates are identified, assessed and managed.

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: Para. 14)

- A55. A review of the outcome or re-estimation of previous accounting estimates (retrospective review) assists in identifying and assessing the risks of material misstatement when previous accounting estimates have an outcome through transfer or realisation of the asset or liability in the current period, or are re-estimated for the purpose of the current period. Through performing a retrospective review, the auditor may obtain:
- Information regarding the effectiveness of management's previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management's current process
 - Audit evidence of matters, such as the reasons for changes that may be required to be disclosed in the financial report.
 - Information regarding the complexity or estimation uncertainty pertaining to the accounting estimates.
 - Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor's professional scepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.
- A56. A retrospective review may provide audit evidence that supports the identification and assessment of the risks of material misstatement in the current period. Such a retrospective review may be performed for accounting estimates made for the prior period's financial report,

³⁶ See ASA 315, paragraph A77.

or may be performed over several periods or a shorter period (such as half-yearly or quarterly). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period.

- A57. A retrospective review of management judgements and assumptions related to significant accounting estimates is required by ASA 240.³⁷ As a practical matter, the auditor's review of previous accounting estimates as a risk assessment procedure in accordance with this Auditing Standard may be carried out in conjunction with the review required by ASA 240.
- A58. Based on the auditor's previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.
- A59. The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projections) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risk of material misstatement in the current period.
- A60. A difference between the outcome of an accounting estimate and the amount recognised in the previous period's financial report does not necessarily represent a misstatement of the previous period's financial report. However, such a difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial report were finalised, or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.³⁸ Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may reassess control risk and may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

Specialised Skills or Knowledge (Ref: Para. 15)

- A61. Matters that may affect the auditor's determination of whether the engagement team requires specialised skills or knowledge, include, for example:³⁹
- The nature of the accounting estimates for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, insurance contract liabilities).
 - The degree of estimation uncertainty.

³⁷ See ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*, paragraph 32(b)(ii).

³⁸ See ASA 560 *Subsequent Events*, paragraph 14.

³⁹ See ASA 220 *Quality Control for an Audit of a Financial Report and Other Historical Financial Information*, paragraph 14 and ASA 300 *Planning an Audit of a Financial Report*, paragraph 8(e).

- The complexity of the method or model used.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice or areas where there are inconsistencies in how accounting estimates are made.
- The procedures the auditor intends to undertake in responding to assessed risks of material misstatement.
- The need for judgement about matters not specified by the applicable financial reporting framework.
- The degree of judgement needed to select data and assumptions.
- The complexity and extent of the entity's use of information technology in making accounting estimates.

The nature, timing and extent of the involvement of individuals with specialised skills and knowledge may vary throughout the audit.

- A62. The auditor may not possess the specialised skills or knowledge necessary when the matter involved is in a field other than accounting or auditing (for example, valuation skills) and may need to use an auditor's expert.⁴⁰
- A63. Many accounting estimates do not require the application of specialised skills or knowledge. For example, specialised skills or knowledge may not be needed for a simple inventory obsolescence calculation. However, for example, for expected credit losses of a banking institution or an insurance contract liability for an insurance entity, the auditor is likely to conclude that it is necessary to apply specialised skills or knowledge.

Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 4, 16)

- A64. Identifying and assessing risks of material misstatement at the assertion level relating to accounting estimates is important for all accounting estimates, including not only those that are recognised in the financial report, but also those that are included in the notes to the financial report.
- A65. Paragraph A42 of ASA 200 states that the Auditing Standards do not ordinarily refer to inherent risk and control risk separately. However, this Auditing Standard requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement, including significant risks, at the assertion level for accounting estimates in accordance with ASA 330.⁴¹
- A66. In identifying the risks of material misstatement and in assessing inherent risk, the auditor is required to take into account the degree to which the accounting estimate is subject to, or affected by, estimation uncertainty, complexity, subjectivity, or other inherent risk factors. The auditor's consideration of the inherent risk factors may also provide information to be used in determining:
- Where inherent risk is assessed on the spectrum of inherent risk; and
 - The reasons for the assessment given to the risks of material misstatement at the assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 are responsive to those reasons.

⁴⁰ See ASA 620 *Using the Work of an Auditor's Expert*.

⁴¹ See ASA 330, paragraph 7(b).

The interrelationships between the inherent risk factors are further explained in Appendix 1.

- A67. The reasons for the auditor's assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors. For example:
- (a) Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgements about future events or conditions. Similar considerations apply to insurance contract liabilities.
 - (b) An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
 - (c) Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgement, for example, an accounting estimate that requires a single critical judgement about a liability, the amount of which is contingent on the outcome of the litigation.
- A68. The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree and the auditor may identify fewer risks or assess inherent risk at the lower end of the spectrum of inherent risk.
- A69. Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree, and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates the auditor's application of professional scepticism may be particularly important.
- A70. Events occurring after the date of the financial report may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the assertion level,⁴² regardless of the degree to which the accounting estimate was subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors. Events occurring after the date of the financial report also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate, and therefore may assess inherent risk at the assertion level at the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level.
- A71. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using

⁴² See ASA 315, paragraph 31.

qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

Estimation Uncertainty (Ref: Para. 16(a))

A72. In taking into account the degree to which the accounting estimate is subject to estimation uncertainty, the auditor may consider:

- Whether the applicable financial reporting framework requires:
 - The use of a method to make the accounting estimate that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of unobservable inputs.
 - The use of assumptions that inherently have a high level of estimation uncertainty, such as assumptions with a long forecast period, assumptions that are based on data that is unobservable and are therefore difficult for management to develop, or the use of various assumptions that are interrelated.
 - Disclosures about estimation uncertainty.
- The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate may therefore be dependent on data that is not readily observable.
- Whether it is possible (or practicable, insofar as permitted by the applicable financial reporting framework) for management:
 - To make a precise and reliable prediction about the future realisation of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount at which an insurance claim will be settled and the timing of its settlement); or
 - To obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial report, to develop a fair value estimate).

A73. The size of the amount recognised or disclosed in the financial report for an accounting estimate is not, in itself, an indicator of its susceptibility to misstatement because, for example, the accounting estimate may be understated.

A74. In some circumstances, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may preclude recognition of an item in the financial report, or its measurement at fair value. In such cases, there may be risks of material misstatement that relate not only to whether an accounting estimate should be recognised, or whether it should be measured at fair value, but also to the reasonableness of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the estimation uncertainty associated with them (see paragraphs A112–A113, A143–A144).

A75. In some cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ASA 570⁴³ establishes requirements and provides guidance in such circumstances.

Complexity or Subjectivity (Ref: Para. 16(b))

The Degree to Which Complexity Affects the Selection and Application of the Method

A76. In taking into account the degree to which the selection and application of the method used in making the accounting estimate are affected by complexity, the auditor may consider:

- The need for specialised skills or knowledge by management which may indicate that the method used to make an accounting estimate is inherently complex and therefore the accounting estimate may have a greater susceptibility to material misstatement. There may be a greater susceptibility to material misstatement when management has developed a model internally and has relatively little experience in doing so, or uses a model that applies a method that is not established or commonly used in a particular industry or environment.
- The nature of the measurement basis required by the applicable financial reporting framework, which may result in the need for a complex method that requires multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them. For example, an expected credit loss provision may require judgements about future credit repayments and other cash flows, based on consideration of historical experience data and the application of forward looking assumptions. Similarly, the valuation of an insurance contract liability may require judgements about future insurance contract payments to be projected based on historical experience and current and assumed future trends.

The Degree to Which Complexity Affects the Selection and Application of the Data

A77. In taking into account the degree to which the selection and application of the data used in making the accounting estimate are affected by complexity, the auditor may consider:

- The complexity of the process to derive the data, taking into account the relevance and reliability of the data source. Data from certain sources may be more reliable than from others. Also, for confidentiality or proprietary reasons, some external information sources will not (or not fully) disclose information that may be relevant in considering the reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed.
- The inherent complexity in maintaining the integrity of the data. When there is a high volume of data and multiple sources of data, there may be inherent complexity in maintaining the integrity of data that is used to make an accounting estimate.
- The need to interpret complex contractual terms. For example, the determination of cash inflows or outflows arising from a commercial supplier or customer rebates may depend on very complex contractual terms that require specific experience or competence to understand or interpret.

The Degree to Which Subjectivity Affects the Selection and Application of the Method, Assumptions or Data

A78. In taking into account the degree to which the selection and application of method, assumptions or data are affected by subjectivity, the auditor may consider:

⁴³ See ASA 570 *Going Concern*.

- The degree to which the applicable financial reporting framework does not specify the valuation approaches, concepts, techniques and factors to use in the estimation method.
- The uncertainty regarding the amount or timing, including the length of the forecast period. The amount and timing is a source of inherent estimation uncertainty, and gives rise to the need for management judgement in selecting a point estimate, which in turn creates an opportunity for management bias. For example, an accounting estimate that incorporates forward looking assumptions may have a high degree of subjectivity which may be susceptible to management bias.

Other Inherent Risk Factors (Ref: Para. 16(b))

- A79. The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or fraud. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is therefore misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

Significant Risks (Ref: Para. 17)

- A80. The auditor's assessment of inherent risk, which takes into account the degree to which an accounting estimate is subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, assists the auditor in determining whether any of the risks of material misstatement identified and assessed are a significant risk.

Responses to the Assessed Risks of Material Misstatement

The Auditor's Further Audit Procedures (Ref: Para. 18)

- A81. In designing and performing further audit procedures the auditor may use any of the three testing approaches (individually or in combination) listed in paragraph 18. For example, when several assumptions are used to make an accounting estimate, the auditor may decide to use a different testing approach for each assumption tested.

Obtaining Relevant Audit Evidence Whether Corroborative or Contradictory

- A82. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.⁴⁴ Obtaining audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence.
- A83. ASA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of the risk.⁴⁵ Therefore, the consideration of the nature or quantity of the audit evidence may be more important when inherent risks relating to an accounting estimate is assessed at the higher end of the spectrum of inherent risk.

⁴⁴ See ASA 500, paragraph A1.

⁴⁵ See ASA 330, paragraph 7(b), A19.

Scalability

- A84. The nature, timing and extent of the auditor's further audit procedures are affected by, for example:
- The assessed risks of material misstatement, which affect the persuasiveness of the audit evidence needed and influence the approach the auditor selects to audit an accounting estimate. For example, the assessed risks of material misstatement relating to the existence or valuation assertions may be lower for a straightforward accrual for bonuses that are paid to employees shortly after period end. In this situation, it may be more practical for the auditor to obtain sufficient appropriate audit evidence by evaluating events occurring up to the date of the auditor's report, rather than through other testing approaches.
 - The reasons for the assessed risks of material misstatement.

When the Auditor Intends to Rely on the Operating Effectiveness of Relevant Controls (Ref: Para: 19)

- A85. Testing the operating effectiveness of relevant controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity, and therefore requires significant judgement by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.
- A86. In determining the nature, timing and extent of testing of the operating effectiveness of controls relating to accounting estimates, the auditor may consider factors such as:
- The nature, frequency and volume of transactions;
 - The effectiveness of the design of the controls, including whether controls are appropriately designed to respond to the assessed inherent risk, and the strength of governance;
 - The importance of particular controls to the overall control objectives and processes in place at the entity, including the sophistication of the information system to support transactions;
 - The monitoring of controls and identified deficiencies in internal control;
 - The nature of the risks the controls are intended to address, for example, controls related to the exercise of judgement compared with controls over supporting data;
 - The competency of those involved in the control activities;
 - The frequency of performance of the control activities; and
 - The evidence of performance of control activities.

Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence

- A87. In some industries, such as the financial services industry, management makes extensive use of IT to conduct business. It may therefore be more likely that there are risks related to certain accounting estimates for which substantive procedures alone cannot provide sufficient appropriate audit evidence.
- A88. Circumstances when risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level may exist include:

- When controls are necessary to mitigate risks relating to the initiation, recording, processing, or reporting of information obtained from outside of the general and subsidiary ledgers.
- Information supporting one or more assertions is electronically initiated, recorded, processed, or reported. This is likely to be the case when there is a high volume of transactions or data, or a complex model is used, requiring the extensive use of information technology to ensure the accuracy and completeness of the information. A complex expected credit loss provision may be required for a financial institution or utility entity. For example, in the case of a utility entity, the data used in developing the expected credit loss provision may comprise many small balances resulting from a high volume of transactions. In these circumstances, the auditor may conclude that sufficient appropriate audit evidence cannot be obtained without testing controls around the model used to develop the expected credit loss provision.

In such cases, the sufficiency and appropriateness of the audit evidence may depend on the effectiveness of controls over the accuracy and completeness of the information.

- A89. As part of the audit of the financial report for certain entities (such as a bank or insurer), the auditor also may be required by law or regulation to undertake additional procedures in relation to, or to provide an assurance conclusion on, internal control. In these and other similar circumstances, the auditor may be able to use information obtained in performing such procedures as audit evidence, subject to determining whether subsequent changes have occurred that may affect its relevance to the audit.

Significant Risks (Ref: Para. 20)

- A90. When the auditor's further audit procedures in response to a significant risk consist only of substantive procedures, ASA 330⁴⁶ requires that those procedures include tests of details. Such tests of details may be designed and performed under each of the approaches described in paragraph 18 of this Auditing Standard based on the auditor's professional judgement in the circumstances. Examples of tests of details for significant risks related to accounting estimates include:
- Examination, for example, examining contracts to corroborate terms or assumptions.
 - Recalculation, for example, verifying the mathematical accuracy of a model.
 - Agreeing assumptions used to supporting documentation, such as third-party published information.

Obtaining Audit Evidence from Events Occurring up to the Date of the Auditor's Report (Ref: Para. 21)

- A91. In some circumstances, obtaining audit evidence from events occurring up to the date of the auditor's report may provide sufficient appropriate audit evidence to address the risks of material misstatement. For example, sale of the complete inventory of a discontinued product shortly after the period end may provide sufficient appropriate audit evidence relating to the estimate of its net realisable value at the period end. In other cases, it may be necessary to use this testing approach in connection with another approach in paragraph 18.
- A92. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide sufficient appropriate audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at

⁴⁶ See ASA 330, paragraph 21.

the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate.

- A93. Even if the auditor decides not to undertake this testing approach in respect of specific accounting estimates, the auditor is required to comply with ASA 560. ASA 560 requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial report and the date of the auditor's report that require adjustment of, or disclosure in, the financial report have been identified⁴⁷ and appropriately reflected in the financial report.⁴⁸ Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under ASA 560 is particularly relevant.

Testing How Management Made the Accounting Estimate (Ref. Para. 22)

- A94. Testing how management made the accounting estimate may be an appropriate approach when, for example:
- The auditor's review of similar accounting estimates made in the prior period financial report suggests that management's current period process is appropriate.
 - The accounting estimate is based on a large population of items of a similar nature that individually are not significant.
 - The applicable financial reporting framework specifies how management is expected to make the accounting estimate. For example, this may be the case for an expected credit loss provision.
 - The accounting estimate is derived from the routine processing of data.

Testing how management made the accounting estimate may also be an appropriate approach when neither of the other testing approaches is practical to perform, or may be an appropriate approach in combination with one of the other testing approaches.

Changes in Methods, Significant Assumptions and the Data from Prior Periods (Ref: Para. 23(a), 24(a), 25(a))

- A95. When a change from prior periods in a method, significant assumption, or the data is not based on new circumstances or new information, or when significant assumptions are inconsistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, the auditor may need to have further discussions with management about the circumstances and, in doing so, challenge management regarding the appropriateness of the assumptions used.

Indicators of Management Bias (Ref: Para. 23(b), 24(b), 25(b))

- A96. When the auditor identifies indicators of possible management bias, the auditor may need a further discussion with management and may need to reconsider whether sufficient appropriate audit evidence has been obtained that the method, assumptions and data used were appropriate and supportable in the circumstances. An example of an indicator of management bias for a particular accounting estimate may be when management has developed an appropriate range for several different assumptions, and in each case the assumption used was from the end of the range that resulted in the most favourable measurement outcome.

⁴⁷ See ASA 560, paragraph 6.

⁴⁸ See ASA 560, paragraph 8.

Methods

The selection of the method (Ref: Para. 23(a))

A97. Relevant considerations for the auditor regarding the appropriateness of the method selected in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:

- Whether management's rationale for the method selected is appropriate;
- Whether the method is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, other available valuation concepts or techniques, regulatory requirements, and the business, industry and environment in which the entity operates;
- When management has determined that different methods result in a range of significantly different estimates, how management has investigated the reasons for these differences; and
- Whether the change is based on new circumstances or new information. When this is not the case, the change may not be reasonable or in compliance with the applicable financial reporting framework. Arbitrary changes result in inconsistent financial report over time and may give rise to financial statement misstatements or may be an indicator of possible management bias. (see also paragraphs A133–A136)

These matters are important when the applicable financial reporting framework does not prescribe the method of measurement or allows multiple methods.

Complex modelling (Ref: Para. 23(d))

A98. A model, and the related method, is more likely to be complex when:

- Understanding and applying the method, including designing the model and selecting and using appropriate data and assumptions, requires specialised skills or knowledge;
- It is difficult to obtain data needed for use in the model because there are restrictions on the availability or observability of, or access to, data; or
- It is difficult to maintain the integrity (e.g., accuracy, consistency, or completeness) of the data and assumptions in using the model due to multiple valuation attributes, multiple relationships between them, or multiple iterations of the calculation.

A99. Matters that the auditor may consider when management uses a complex model include, for example, whether:

- The model is validated prior to usage or when there has been a change to the model, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
 - The model's theoretical soundness;
 - The model's mathematical integrity;
 - The accuracy and completeness of the model's data and assumptions; and
 - The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- Management uses appropriate skills and knowledge in using the model.

These considerations may also be useful for a method that does not involve complex modelling.

- A100. Management may make adjustments to the output of the model to meet the requirements of the applicable financial reporting framework. In some industries these adjustments are referred to as overlays. In the case of fair value accounting estimates, it may be relevant to consider whether adjustments to the output of the model, if any, reflect the assumptions marketplace participants would use in similar circumstances.

Maintenance of integrity of significant assumptions and the data used in applying the method
(Ref: Para. 23(e))

- A101. Maintaining the integrity of significant assumptions and the data in applying the method refers to the maintenance of the accuracy and completeness of the data and assumptions through all stages of information processing. A failure to maintain such integrity may result in corruption of the data and assumptions and may give rise to misstatements. In this regard, relevant considerations for the auditor may include whether the data and assumptions are subject to all changes intended by management, and not subject to any unintended changes, during activities such as input, storage, retrieval, transmission or processing.

Significant Assumptions (Ref: Para. 24)

- A102. Relevant considerations for the auditor regarding the appropriateness of the significant assumptions in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:
- Management's rationale for the selection of the assumption;
 - Whether the assumption is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry and environment in which the entity operates; and
 - Whether a change from prior periods in selecting an assumption is based on new circumstances or new information. When it is not, the change may not be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate may give rise to material misstatements of the financial report or may be an indicator of possible management bias (see paragraphs A133–A136).
- A103. Management may evaluate alternative assumptions or outcomes of accounting estimates, which may be accomplished through a number of approaches depending on the circumstances. One possible approach is a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value, there may be variation because different market participants will use different assumptions. A sensitivity analysis may lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, and including 'pessimistic' and 'optimistic' scenarios.
- A104. Through the knowledge obtained in performing the audit, the auditor may become aware of or may have obtained an understanding of assumptions used in other areas of the entity's business. Such matters may include, for example, business prospects, assumptions in strategy documents and future cash flows. Also, if the engagement partner has performed other engagements for the entity, ASA 315⁴⁹ requires the engagement partner to consider whether information obtained from those other engagements is relevant to identifying risks of material misstatement. This information may also be useful to consider in addressing whether

⁴⁹ See ASA 315, paragraph 8.

significant assumptions are consistent with each other and with those used in other accounting estimates.

A105. The appropriateness of the significant assumptions in the context of the requirements of the applicable financial reporting framework may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the applicable financial reporting framework may require management to do so. The nature and extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgement. When applicable, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Inspection of written plans and other documentation, including, when applicable, formally approved budgets, authorisations or minutes.
- Enquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial report and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments and legal, regulatory, or contractual restrictions that could affect the feasibility of management's actions.
- Consideration of whether management has met the applicable documentation requirements, if any, of the applicable financial reporting framework.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that significant assumptions reflect those used by marketplace participants.

Data (Ref: Para. 25(a))

A106. Relevant considerations for the auditor regarding the appropriateness of the data selected for use in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of the changes from the prior period may include:

- Management's rationale for the selection of the data;
- Whether the data is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry and environment in which the entity operates; and
- Whether the change from prior periods in the sources or items of data selected or data selected, is based on new circumstances or new information. When it is not, it is unlikely to be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate result in inconsistent financial report over time and may give rise to financial statement misstatements or may be an indicator of possible management bias (see paragraphs A133–A136).

Relevance and reliability of the data (Ref: Para. 25(c))

A107. When using information produced by the entity, ASA 500 requires the auditor to evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances, to obtain audit evidence about the accuracy and completeness

of the information and evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.⁵⁰

Complex legal or contractual terms (Ref: Para. 25(d))

A108. Procedures that the auditor may consider when the accounting estimate is based on complex legal or contractual terms include:

- Considering whether specialised skills or knowledge are needed to understand or interpret the contract;
- Enquiring of the entity's legal counsel regarding the legal or contractual terms; and
- Inspecting the underlying contracts to:
 - Evaluate, the underlying business purpose for the transaction or agreement; and
 - Consider whether the terms of the contracts are consistent with management's explanations.

Management's Selection of a Point Estimate and Related Disclosures about Estimation Uncertainty

Management's steps to understand and address estimation uncertainty (Ref: Para. 26(a))

A109. Relevant considerations regarding whether management has taken appropriate steps to understand and address estimation uncertainty may include whether management has:

- (a) Understood the estimation uncertainty, through identifying the sources, and assessing the degree of inherent variability in the measurement outcomes and the resulting range of reasonably possible measurement outcomes;
- (b) Identified the degree to which, in the measurement process, complexity or subjectivity affect the risk of material misstatement, and addressed the resulting potential for misstatement through applying:
 - (i) Appropriate skills and knowledge in making accounting estimates; and
 - (ii) Professional judgement, including by identifying and addressing susceptibility to management bias; and
- (c) Addressed estimation uncertainty through appropriately selecting management's point estimate and related disclosures that describe the estimation uncertainty.

The selection of management's point estimate and related disclosures of estimation uncertainty (Ref: Para. 26(b))

A110. Matters that may be relevant regarding the selection of management's point estimate and the development of related disclosures about estimation uncertainty include whether:

- The methods and data used were selected appropriately, including when alternative methods for making the accounting estimate and alternative sources of data were available.
- Valuation attributes used were appropriate and complete.

⁵⁰ See ASA 500, paragraph 9.

- The assumptions used were selected from a range of reasonably possible amounts and were supported by appropriate data that is relevant and reliable.
- The data used was appropriate, relevant and reliable, and the integrity of that data was maintained.
- The calculations were applied in accordance with the method and were mathematically accurate.
- Management's point estimate is appropriately chosen from the reasonably possible measurement outcomes.
- The related disclosures appropriately describe the amount as an estimate and explain the nature and limitations of the estimation process, including the variability of the reasonably possible measurement outcomes.

A111. Relevant considerations for the auditor regarding the appropriateness of management's point estimate, may include:

- When the requirements of the applicable financial reporting framework prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribes a specific measurement method, whether management has followed the requirements of the applicable financial reporting framework.
- When the applicable financial reporting framework has not specified how to select an amount from reasonably possible measurement outcomes, whether management has exercised judgement, taking into account the requirements of the applicable financial reporting framework.

A112. Relevant considerations for the auditor regarding management's disclosures about estimation uncertainty include the requirements of the applicable financial reporting framework, which may require disclosures:

- That describe the amount as an estimate and explain the nature and limitations of the process for making it, including the variability in reasonably possible measurement outcomes. The framework also may require additional disclosures to meet a disclosure objective.⁵¹
- About significant accounting policies related to accounting estimates. Depending on the circumstances, relevant accounting policies may include matters such as the specific principles, bases, conventions, rules and practices applied in preparing and presenting accounting estimates in the financial report.
- About significant or critical judgements (for example, those that had the most significant effect on the amounts recognised in the financial report) as well as significant forward-looking assumptions or other sources of estimation uncertainty.

In certain circumstances, additional disclosures beyond those explicitly required by the financial reporting framework may be needed in order to achieve fair presentation, or in the case of a compliance framework, for the financial report not to be misleading.

A113. The greater the degree to which an accounting estimate is subject to estimation uncertainty, the more likely the risks of material misstatement will be assessed as higher and therefore the more persuasive the audit evidence needs to be to determine, in accordance with paragraph 35,

⁵¹ See Accounting Standard AASB 13 *Fair Value Measurement*, paragraph 92.

whether management's point estimate and related disclosures about estimation uncertainty are reasonable in the context of the applicable financial reporting framework, or are misstated.

- A114. If the auditor's consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter.⁵²

When Management Has Not Taken Appropriate Steps to Understand and Address Estimation Uncertainty (Ref: Para. 27)

- A115. When the auditor determines that management has not taken appropriate steps to understand and address estimation uncertainty, additional procedures that the auditor may request management to perform to understand estimation uncertainty may include, for example, consideration of alternative assumptions or the performance of a sensitivity analysis.
- A116. In considering whether it is practicable to develop a point estimate or range, matters the auditor may need to take into account include whether the auditor could do so without compromising independence requirements. This may include relevant ethical requirements that address prohibitions on assuming management responsibilities.
- A117. If, after considering management's response, the auditor determines that it is not practicable to develop an auditor's point estimate or range, the auditor is required to evaluate the implications for the audit or the auditor's opinion on the financial report in accordance with paragraph 34.

Developing an Auditor's Point Estimate or Using an Auditor's Range (Ref: Para. 28–29)

- A118. Developing an auditor's point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty may be an appropriate approach when, for example:
- The auditor's review of similar accounting estimates made in the prior period financial report suggests that management's current period process is not expected to be effective.
 - The entity's controls within and over management's process for making accounting estimates are not well designed or properly implemented.
 - Events or transactions between the period end and the date of the auditor's report have not been properly taken into account, when it is appropriate for management to do so, and such events or transactions appear to contradict management's point estimate.
 - There are appropriate alternative assumptions or sources of relevant data that can be used in developing an auditor's point estimate or a range.
 - Management has not taken appropriate steps to understand or address the estimation uncertainty (see paragraph 27).
- A119. The decision to develop a point estimate or range also may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value, or the most likely outcome).
- A120. The auditor's decision as to whether to develop a point estimate rather than a range may depend on the nature of the estimate and the auditor's judgement in the circumstances. For

⁵² See ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.

example, the nature of the estimate may be such that there is expected to be less variability in the reasonably possible outcomes. In these circumstances, developing a point estimate may be an effective approach, particularly when it can be developed with a higher degree of precision.

A121. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a different model than the one used by management, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Using management's model but developing alternative assumptions or data sources to those used by management.
- Using the auditor's own method but developing alternative assumptions to those used by management.
- Employing or engaging a person with specialised expertise to develop or execute a model, or to provide relevant assumptions.
- Consideration of other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

A122. The auditor also may develop a point estimate or range for only part of the accounting estimate (for example, for a particular assumption, or when only a certain part of the accounting estimate is giving rise to the risk of material misstatement).

A123. When using the auditor's own methods, assumptions or data to develop a point estimate or range, the auditor may obtain evidence about the appropriateness of management's methods, assumptions or data. For example, if the auditor uses the auditor's own assumptions in developing a range to evaluate the reasonableness of management's point estimate, the auditor may also develop a view about whether management's judgements in selecting the significant assumptions used in making the accounting estimate give rise to indicators of possible management bias.

A124. The requirement in paragraph 29(a) for the auditor to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence does not mean that the auditor is expected to obtain audit evidence to support each possible outcome in the range individually. Rather, the auditor is likely to obtain evidence to determine that the points at both ends of the range are reasonable in the circumstances, thereby supporting that amounts falling between those two points also are reasonable.

A125. The size of the auditor's range may be multiples of materiality for the financial report as a whole, particularly when materiality is based on operating results (for example, pre-tax income) and this measure is relatively small in relation to assets or other balance sheet measures. This situation is more likely to arise in circumstances when the estimation uncertainty associated with the accounting estimate is itself multiples of materiality, which is more common for certain types of accounting estimates or in certain industries, such as insurance or banking, where a high degree of estimation uncertainty is more typical and there may be specific requirements in the applicable financial reporting framework in that regard. Based on the procedures performed and audit evidence obtained in accordance with the requirements of this Auditing Standard, the auditor may conclude that a range that is multiples of materiality is, in the auditor's judgement, appropriate in the circumstances. When this is the case, the auditor's evaluation of the reasonableness of the disclosures about estimation uncertainty becomes increasingly important, particularly whether such disclosures appropriately convey the high degree of estimation uncertainty and the range of possible outcomes. Paragraphs A139–A144 include additional considerations that may be relevant in these circumstances.

Other Considerations Relating to Audit Evidence (Ref: Para. 30)

A126. Information to be used as audit evidence, regarding risks of material misstatement relating to accounting estimates, may have been produced by the entity, prepared using the work of a management's expert, or provided by an external information source.

External Information Sources

A127. As explained in ASA 500,⁵³ the reliability of information from an external information source is influenced by its source, its nature, and the circumstances under which it is obtained. Consequently, the nature and extent of the auditor's further audit procedures to consider the reliability of the information used in making an accounting estimate may vary depending on the nature of these factors. For example:

- When market or industry data, prices, or pricing related data, are obtained from a single external information source, specializing in such information, the auditor may seek a price from an alternative independent source with which to compare.
- When market or industry data, prices, or pricing related data, are obtained from multiple independent external information sources and points to consensus across those sources, the auditor may need to obtain less evidence about the reliability of the data from an individual source.
- When information obtained from multiple information sources points to divergent market views the auditor may seek to understand the reasons for the diversity in views. The diversity may result from the use of different methods, assumptions, or data. For example, one source may be using current prices and another source using future prices. When the diversity relates to estimation uncertainty, the auditor is required by paragraph 26(b) to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, the disclosures in the financial report that describe the estimation uncertainty are reasonable. In such cases professional judgement is also important in considering information about the methods, assumptions or data applied.
- When information obtained from an external information source has been developed by that source using its own model(s). Paragraph A33F of ASA 500 provides relevant guidance.

A128. For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include:

- (a) Whether fair values are based on trades of the same instrument or active market quotations;
- (b) When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;
- (c) When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable; and
- (d) When the fair value measurement is based on a broker quote, whether the broker quote:

⁵³ See ASA 500, Paragraph A31.

- (i) Is from a market maker who transacts in the same type of financial instrument;
- (ii) Is binding or nonbinding, with more weight placed on quotes based on binding offers; and
- (iii) Reflects market conditions as of the date of the financial report, when required by the applicable financial reporting framework.

A129. When information from an external information source is used as audit evidence, a relevant consideration for the auditor may be whether information can be obtained, or whether the information is sufficiently detailed, to understand the methods, assumptions and other data used by the external information source. This may be limited in some respects and consequently influence the auditor's consideration of the nature, timing and extent of procedures to perform. For example, pricing services often provide information about their methods and assumptions by asset class rather than individual securities. Brokers often provide only limited information about their inputs and assumptions when providing broker indicative quotes for individual securities. Paragraph A33Ga of ASA 500 provides guidance with respect to restrictions placed by the external information source on the provision of supporting information.

Management's Expert

- A130. Assumptions relating to accounting estimates that are made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate. Accordingly, the auditor applies the relevant requirements in this Auditing Standard to those assumptions.
- A131. If the work of a management's expert involves the use of methods or sources of data relating to accounting estimates, or developing or providing findings or conclusions relating to a point estimate or related disclosures for inclusion in the financial report, the requirements in paragraphs 21–29 of this Auditing Standard may assist the auditor in applying paragraph 8(c) of ASA 500.

Service Organisations

- A132. ASA 402⁵⁴ deals with the auditor's understanding of the services provided by a service organisation, including internal control, as well as the auditor's responses to assessed risks of material misstatement. When the entity uses the services of a service organisation in making accounting estimates, the requirements and guidance in ASA 402 may therefore assist the auditor in applying the requirements of this Auditing Standard.

Indicators of Possible Management Bias (Ref: Para. 32)

- A133. Management bias may be difficult to detect at an account level and may only be identified by the auditor when considering groups of accounting estimates, all accounting estimates in aggregate, or when observed over a number of accounting periods. For example, if accounting estimates included in the financial report are considered to be individually reasonable but management's point estimates consistently trend toward one end of the auditor's range of reasonable outcomes that provide a more favourable financial reporting outcome for management, such circumstances may indicate possible bias by management.
- A134. Examples of indicators of possible management bias with respect to accounting estimates include:

⁵⁴ See ASA 402 *Audit Considerations Relating to an Entity Using a Service Organisation*.

- Changes in an accounting estimate, or the method for making it, when management has made a subjective assessment that there has been a change in circumstances.
- Selection or development of significant assumptions or the data that yield a point estimate favourable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

When such indicators are identified, there may be a risk of material misstatement either at the assertion or financial statement level. Indicators of possible management bias themselves do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. However, in some cases the audit evidence may point to a misstatement rather than simply an indicator of management bias.

- A135. Indicators of possible management bias may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate. The auditor may also need to consider the implications for other aspects of the audit, including the need to further question the appropriateness of management's judgements in making accounting estimates. Further, indicators of possible management bias may affect the auditor's conclusion as to whether the financial report as a whole are free from material misstatement, as discussed in ASA 700.⁵⁵
- A136. In addition, in applying ASA 240, the auditor is required to evaluate whether management's judgements and decisions in making the accounting estimates included in the financial report indicate a possible bias that may represent a material misstatement due to fraud.⁵⁶ Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating accounting estimates. Indicators of possible management bias that may also be a fraud risk factor, may cause the auditor to reassess whether the auditor's risk assessments, in particular the assessment of fraud risks, and related responses remain appropriate.

Overall Evaluation Based on Audit Procedures Performed (Ref: Para. 33)

- A137. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures.⁵⁷ In relation to accounting estimates, information may come to the auditor's attention through performing procedures to obtain audit evidence that differs significantly from the information on which the risk assessment was based. For example, the auditor may have identified that the only reason for an assessed risk of material misstatement is the subjectivity involved in making the accounting estimate. However, while performing procedures to respond to the assessed risks of material misstatement, the auditor may discover that the accounting estimate is more complex than originally contemplated, which may call into question the assessment of the risk of material misstatement (for example, the inherent risk may need to be re-assessed on the higher end of the spectrum of inherent risk due to the effect of complexity) and therefore the auditor may need to perform additional further audit procedures to obtain sufficient appropriate audit evidence.⁵⁸
- A138. With respect to accounting estimates that have not been recognised, a particular focus of the auditor's evaluation may be on whether the recognition criteria of the applicable financial reporting framework have in fact been met. When an accounting estimate has not been recognised, and the auditor concludes that this treatment is appropriate, some financial reporting frameworks may require disclosure of the circumstances in the notes to the financial report.

⁵⁵ See ASA 700, paragraph 11.

⁵⁶ See ASA 240, paragraph 32(b).

⁵⁷ See ASA 330, paragraph A60.

⁵⁸ See also ASA 315, paragraph 31.

Determining Whether the Accounting Estimates are Reasonable or Misstated (Ref: Para. 9, 35)

- A139. In determining whether, based on the audit procedures performed and evidence obtained, management's point estimate and related disclosures are reasonable, or are misstated:
- When the audit evidence supports a range, the size of the range may be wide and, in some circumstances, may be multiples of materiality for the financial report as a whole (see also paragraph A125). Although a wide range may be appropriate in the circumstances, it may indicate that it is important for the auditor to reconsider whether sufficient appropriate audit evidence has been obtained regarding the reasonableness of the amounts within the range.
 - The audit evidence may support a point estimate that differs from management's point estimate. In such circumstances, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement.
 - The audit evidence may support a range that does not include management's point estimate. In such circumstances, the misstatement is the difference between management's point estimate and the nearest point of the auditor's range.
- A140. Paragraphs A110–A114 provide guidance to assist the auditor in evaluating management's selection of a point estimate and related disclosures to be included in the financial report.
- A141. When the auditor's further audit procedures include testing how management made the accounting estimate or developing an auditor's point estimate or range, the auditor is required to obtain sufficient appropriate audit evidence about disclosures that describe estimation uncertainty in accordance with paragraphs 26(b) and 29(b) and other disclosures in accordance with paragraph 31. The auditor then considers the audit evidence obtained about disclosures as part of the overall evaluation, in accordance with paragraph 35, of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.
- A142. ASA 450 also provides guidance regarding qualitative disclosures⁵⁹ and when misstatements in disclosures could be indicative of fraud.⁶⁰
- A143. When the financial report are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial report achieve fair presentation⁶¹ includes the consideration of the overall presentation, structure and content of the financial report, and whether the financial report, including the related notes, represent the transactions and events in a manner that achieves fair presentation. For example, when an accounting estimate is subject to a higher degree of estimation uncertainty, the auditor may determine that additional disclosures are necessary to achieve fair presentation. If management does not include such additional disclosures, the auditor may conclude that the financial report are materially misstated.
- A144. ASA 705⁶² provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosures in the financial report are inadequate or misleading, including, for example, with respect to estimation uncertainty.

Written Representations (Ref: Para. 37)

- A145. Written representations about specific accounting estimates may include representations:

⁵⁹ See ASA 450, paragraph A17.

⁶⁰ See ASA 450, paragraph A22.

⁶¹ See ASA 700, paragraph 14.

⁶² See ASA 705, paragraphs 22–23.

- That the significant judgements made in making the accounting estimates have taken into account all relevant information of which management is aware.
- About the consistency and appropriateness in the selection or application of the methods, assumptions and data used by management in making the accounting estimates.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, when relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates, including disclosures describing estimation uncertainty, are complete and are reasonable in the context of the applicable financial reporting framework.
- That appropriate specialised skills or expertise has been applied in making the accounting estimates.
- That no subsequent event requires adjustment to the accounting estimates and related disclosures included in the financial report.
- When accounting estimates are not recognised or disclosed in the financial report, about the appropriateness of management's decision that the recognition or disclosure criteria of the applicable financial reporting framework have not been met.

Communication with Those Charged With Governance, Management or Other Relevant Parties

(Ref: Para. 38)

- A146. In applying ASA 260, the auditor communicates with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices relating to accounting estimates and related disclosures.⁶³ Appendix 2 includes matters specific to accounting estimates that the auditor may consider communicating to those charged with governance.
- A147. ASA 265 requires the auditor to communicate in writing to those charged with governance significant deficiencies in internal control identified during the audit.⁶⁴ Such significant deficiencies may include those related to controls over:
- (a) The selection and application of significant accounting policies, and the selection and application of methods, assumptions and data;
 - (b) Risk management and related systems;
 - (c) Data integrity, including when data is obtained from an external information source; and
 - (d) The use, development and validation of models, including models obtained from an external provider, and any adjustments that may be required.
- A148. In addition to communicating with those charged with governance, the auditor may be permitted or required to communicate directly with regulators or prudential supervisors. Such communication may be useful throughout the audit or at particular stages, such as when planning the audit or when finalizing the auditor's report. For example, in some jurisdictions, financial institution regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, expected credit losses, and insurance reserves while

⁶³ See ASA 260, paragraph 16(a).

⁶⁴ See ASA 265, paragraph 9.

other regulators may seek to understand the auditor's views on significant aspects of the entity's operations including the entity's costs estimates. This communication may be helpful to the auditor in identifying, assessing and responding to risks of material misstatement.

Documentation (Ref: Para. 39)

- A149. ASA 315⁶⁵ and ASA 330⁶⁶ provide requirements and guidance on documenting the auditor's understanding of the entity, risk assessments and responses to assessed risks. This guidance is based on the requirements and guidance in ASA 230.⁶⁷ In the context of auditing accounting estimates, the auditor is required to prepare audit documentation about key elements of the auditor's understanding of the entity and its environment related to accounting estimates. In addition, the auditor's judgements about the assessed risks of material misstatement related to accounting estimates, and the auditor's responses, may likely be further supported by documentation of communications with those charged with governance and management.
- A150. In documenting the linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level, in accordance with ASA 330, this Auditing Standard requires that the auditor take into account the reasons given to the risks of material misstatement at the assertion level. Those reasons may relate to one or more inherent risk factors or the auditor's assessment of control risk. However, the auditor is not required to document how every inherent risk factor was taken into account in identifying and assessing the risks of material misstatement in relation to each accounting estimate.
- A151. The auditor also may consider documenting:
- When management's application of the method involves complex modelling, whether management's judgements have been applied consistently and, when applicable, that the design of the model meets the measurement objective of the applicable financial reporting framework.
 - When the selection and application of methods, significant assumptions, or the data is affected by complexity to a higher degree, the auditor's judgements in determining whether specialised skills or knowledge are required to perform the risk assessment procedures, to design and perform procedures responsive to those risks, or to evaluate the audit evidence obtained. In these circumstances, the documentation also may include how the required skills or knowledge were applied.
- A152. Paragraph A7 of ASA 230 notes that, although there may be no single way in which the auditor's exercise of professional scepticism is documented, the audit documentation may nevertheless provide evidence of the auditor's exercise of professional scepticism. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgements made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained. Examples of other requirements in this Auditing Standard for which documentation may provide evidence of the exercise of professional scepticism by the auditor include:
- Paragraph 13(d), regarding how the auditor has applied an understanding in developing the auditor's own expectation of the accounting estimates and related disclosures to be included in the entity's financial report and how that expectation compares with the entity's financial report prepared by management;
 - Paragraph 18, which requires further audit procedures to be designed and performed to obtain sufficient appropriate evidence in a manner that is not biased toward obtaining

⁶⁵ See ASA 315, paragraphs 32 and A152–A155.

⁶⁶ See ASA 330, paragraphs 28 and A63.

⁶⁷ See ASA 230, paragraph 8(c).

audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory;

- Paragraphs 23(b), 24(b), 25(b) and 32, which address indicators of possible management bias; and
- Paragraph 34, which addresses the auditor's consideration of all relevant audit evidence, whether corroborative or contradictory.

Appendix 1

(Ref: Para. 2, 4, 12(c), A8, A66)

INHERENT RISK FACTORS

Introduction

1. In identifying, assessing and responding to the risks of material misstatement at the assertion level for an accounting estimate and related disclosures, this Auditing Standard requires the auditor to take into account the degree to which the accounting estimate is subject to estimation uncertainty, and the degree to which the selection and application of the methods, assumptions and data used in making the accounting estimate, and the selection of management's point estimate and related disclosures for inclusion in the financial report, are affected by complexity, subjectivity or other inherent risk factors.
40. Inherent risk related to an accounting estimate is the susceptibility of an assertion about the accounting estimate to material misstatement, before consideration of controls. Inherent risk results from inherent risk factors, which give rise to challenges in appropriately making the accounting estimate. This Appendix provides further explanation about the nature of the inherent risk factors of estimation uncertainty, subjectivity and complexity, and their inter-relationships, in the context of making accounting estimates and selecting management's point estimate and related disclosures for inclusion in the financial report.

Measurement Basis

41. The measurement basis and the nature, condition and circumstances of the financial statement item give rise to relevant valuation attributes. When the cost or price of the item cannot be directly observed, an accounting estimate is required to be made by applying an appropriate method and using appropriate data and assumptions. The method may be specified by the applicable financial reporting framework, or is selected by management, to reflect the available knowledge about how the relevant valuation attributes would be expected to influence the cost or price of the item on the measurement basis.

Estimation Uncertainty

42. Susceptibility to a lack of precision in measurement is often referred to in accounting frameworks as measurement uncertainty. Estimation uncertainty is defined in this Auditing Standard as susceptibility to an inherent lack of precision in measurement. It arises when the required monetary amount for a financial statement item that is recognised or disclosed in the financial report cannot be measured with precision through direct observation of the cost or price. When direct observation is not possible, the next most precise alternative measurement strategy is to apply a method that reflects the available knowledge about cost or price for the item on the relevant measurement basis, using observable data about relevant valuation attributes.
43. However, constraints on the availability of such knowledge or data may limit the verifiability of such inputs to the measurement process and therefore limit the precision of measurement outcomes. Furthermore, most accounting frameworks acknowledge that there are practical constraints on the information that should be taken into account, such as when the cost of obtaining it would exceed the benefits. The lack of precision in measurement arising from these constraints is inherent because it cannot be eliminated from the measurement process. Accordingly, such constraints are sources of estimation uncertainty. Other sources of measurement uncertainty that may occur in the measurement process are, at least in principle, capable of elimination if the method is applied appropriately and therefore are sources of potential misstatement rather than estimation uncertainty.

44. When estimation uncertainty relates to uncertain future inflows or outflows of economic benefits that will ultimately result from the underlying asset or liability, the outcome of these flows will only be observable after the date of the financial report. Depending on the nature of the applicable measurement basis and on the nature, condition and circumstances of the financial statement item, this outcome may be directly observable before the financial report are finalised or may only be directly observable at a later date. For some accounting estimates, there may be no directly observable outcome at all.
45. Some uncertain outcomes may be relatively easy to predict with a high level of precision for an individual item. For example, the useful life of a production machine may be easily predicted if sufficient technical information is available about its average useful life. When it is not possible to predict a future outcome, such as an individual's life expectancy based on actuarial assumptions, with reasonable precision, it may still be possible to predict that outcome for a group of individuals with greater precision. Measurement bases may, in some cases, indicate a portfolio level as the relevant unit of account for measurement purposes, which may reduce inherent estimation uncertainty.

Complexity

46. Complexity (i.e., the complexity inherent in the process of making an accounting estimate, before consideration of controls) gives rise to inherent risk. Inherent complexity may arise when:
- There are many valuation attributes with many or non-linear relationships between them.
 - Determining appropriate values for one or more valuation attributes requires multiple data sets.
 - More assumptions are required in making the accounting estimate, or when there are correlations between the required assumptions.
 - The data used is inherently difficult to identify, capture, access or understand.
47. Complexity may be related to the complexity of the method and of the computational process or model used to apply it. For example, complexity in the model may reflect the need to apply probability-based valuation concepts or techniques, option pricing formulae or simulation techniques to predict uncertain future outcomes or hypothetical behaviours. Similarly, the computational process may require data from multiple sources, or multiple data sets to support the making of an assumption or the application of sophisticated mathematical or statistical concepts.
48. The greater the complexity, the more likely it is that management will need to apply specialised skills or knowledge in making an accounting estimate or engage a management's expert, for example in relation to:
- Valuation concepts and techniques that could be used in the context of the measurement basis and objectives or other requirements of the applicable financial reporting framework and how to apply those concepts or techniques;
 - The underlying valuation attributes that may be relevant given the nature of the measurement basis and the nature, condition and circumstances of the financial statement items for which accounting estimates are being made; or
 - Identifying appropriate sources of data from internal sources (including from sources outside the general or subsidiary ledgers) or from external information sources, determining how to address potential difficulties in obtaining data from such sources or in maintaining its integrity in applying the method, or understanding the relevance and reliability of that data.

49. Complexity relating to data may arise, for example, in the following circumstances:
- (a) When data is difficult to obtain or when it relates to transactions that are not generally accessible. Even when such data is accessible, for example through an external information source, it may be difficult to consider the relevance and reliability of the data, unless the external information source discloses adequate information about the underlying data sources it has used and about any data processing that has been performed.
 - (b) When data reflecting an external information source's views about future conditions or events, which may be relevant in developing support for an assumption, is difficult to understand without transparency about the rationale and information taken into account in developing those views.
 - (c) When certain types of data are inherently difficult to understand because they require an understanding of technically complex business or legal concepts, such as may be required to properly understand data that comprises the terms of legal agreements about transactions involving complex financial instruments or insurance products.

Subjectivity

50. Subjectivity (i.e., the subjectivity inherent in the process of making an accounting estimate, before consideration of controls) reflects inherent limitations in the knowledge or data reasonably available about valuation attributes. When such limitations exist, the applicable financial reporting framework may reduce the degree of subjectivity by providing a required basis for making certain judgements. Such requirements may, for example, set explicit or implied objectives relating to measurement, disclosure, the unit of account, or the application of a cost constraint. The applicable financial reporting framework may also highlight the importance of such judgements through requirements for disclosures about those judgements.
51. Management judgement is generally needed in determining some or all of the following matters, which often involve subjectivity:
- To the extent not specified under the requirements of the applicable financial reporting framework, the appropriate valuation approaches, concepts, techniques and factors to use in the estimation method, having regard to available knowledge;
 - To the extent valuation attributes are observable when there are various potential sources of data, the appropriate sources of data to use;
 - To the extent valuation attributes are not observable, the appropriate assumptions or range of assumptions to make, having regard to the best available data, including, for example, market views;
 - The range of reasonably possible outcomes from which to select management's point estimate, and the relative likelihood that certain points within that range would be consistent with the objectives of the measurement basis required by the applicable financial reporting framework; and
 - The selection of management's point estimate, and the related disclosures to be made, in the financial report.
52. Making assumptions about future events or conditions involves the use of judgement, the difficulty of which varies with the degree to which those events or conditions are uncertain. The precision with which it is possible to predict uncertain future events or conditions depends on the degree to which those events or conditions are determinable based on knowledge, including knowledge of past conditions, events and related outcomes. The lack of precision also contributes to estimation uncertainty, as described above.

53. With respect to future outcomes, assumptions will only need to be made for those features of the outcome that are uncertain. For example, in considering the measurement of a possible impairment of a receivable for a sale of goods at the balance sheet date, the amount of the receivable may be unequivocally established and directly observable in the related transaction documents. What may be uncertain is the amount, if any, for loss due to impairment. In this case, assumptions may only be required about the likelihood of loss and about the amount and timing of any such loss.
54. However, in other cases, the amounts of cash flows embodied in the rights relating to an asset may be uncertain. In those cases, assumptions may have to be made about both the amounts of the underlying rights to cash flows and about potential losses due to impairment.
55. It may be necessary for management to consider information about past conditions and events, together with current trends and expectations about future developments. Past conditions and events provide historical information that may highlight repeating historical patterns that can be extrapolated in evaluating future outcomes. Such historical information may also indicate changing patterns of such behaviour over time (cycles or trends). These may suggest that the underlying historical patterns of behaviour have been changing in somewhat predictable ways that may also be extrapolated in evaluating future outcomes. Other types of information may also be available that indicate possible changes in historical patterns of such behaviour or in related cycles or trends. Difficult judgements may be needed about the predictive value of such information.
56. The extent and nature (including the degree of subjectivity involved) of the judgements taken in making the accounting estimates may create opportunity for management bias in making decisions about the course of action that, according to management, is appropriate in making the accounting estimate. When there is also a high level of complexity or a high level of estimation uncertainty, or both, the risk of, and opportunity for, management bias or fraud may also be increased.

Relationship of Estimation Uncertainty to Subjectivity and Complexity

57. Estimation uncertainty gives rise to inherent variation in the possible methods, data sources and assumptions that could be used to make an accounting estimate. This gives rise to subjectivity, and hence, the need for the use of judgement in making the accounting estimate. Such judgements are required in selecting the appropriate methods and data sources, in making the assumptions, and in selecting management's point estimate and related disclosures for inclusion in the financial report. These judgements are made in the context of the recognition, measurement, presentation and disclosure requirements of the applicable financial reporting framework. However, because there are constraints on the availability and accessibility of knowledge or information to support these judgements, they are subjective in nature.
58. Subjectivity in such judgements creates the opportunity for unintentional or intentional management bias in making them. Many accounting frameworks require that information prepared for inclusion in the financial report should be neutral (i.e., that it should not be biased). Given that bias can, at least in principle, be eliminated from the estimation process, sources of potential bias in the judgements made to address subjectivity are sources of potential misstatement rather than sources of estimation uncertainty.
59. The inherent variation in the possible methods, data sources and assumptions that could be used to make an accounting estimate (see paragraph 19) also gives rise to variation in the possible measurement outcomes. The size of the range of reasonably possible measurement outcomes results from the degree of estimation uncertainty and is often referred to as the sensitivity of the accounting estimate. In addition to determining measurement outcomes, an estimation process also involves analysing the effect of inherent variations in the possible methods, data sources and assumptions on the range of reasonably possible measurement outcomes (referred to as sensitivity analysis).

60. Developing a financial statement presentation for an accounting estimate, which, when required by the applicable financial reporting framework, achieves faithful representation (i.e., complete, neutral and free from error) includes making appropriate judgements in selecting a management point estimate that is appropriately chosen from within the range of reasonably possible measurement outcomes and related disclosures that appropriately describe the estimation uncertainty. These judgements may themselves involve subjectivity, depending on the nature of the requirements in the applicable financial reporting framework that address these matters. For example, the applicable financial reporting framework may require a specific basis (such as a probability weighted average or a best estimate) for the selection of the management point estimate. Similarly, it may require specific disclosures or disclosures that meet specified disclosure objectives or additional disclosures that are required to achieve fair presentation in the circumstances.
61. Although an accounting estimate that is subject to a higher degree of estimation uncertainty may be less precisely measurable than one subject to a lower degree of estimation uncertainty, the accounting estimate may still have sufficient relevance for users of the financial report to be recognised in the financial report if, when required by the applicable financial reporting framework, a faithful representation of the item can be achieved. In some cases, estimation uncertainty may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be recognised in the financial report. Even in these circumstances, there may still be relevant disclosure requirements, for example to disclose the point estimate or range of reasonably possible measurement outcomes and information describing the estimation uncertainty and constraints in recognising the item. The requirements of the applicable financial reporting framework that apply in these circumstances may be specified to a greater or lesser degree. Accordingly, in these circumstances, there may be additional judgements that involve subjectivity to be made.

Appendix 2

(Ref: Para. A146)

COMMUNICATIONS WITH THOSE CHARGED WITH GOVERNANCE

Matters that the auditor may consider communicating with those charged with governance with respect to the auditor's views about significant qualitative aspects of the entity's accounting practices related to accounting estimates and related disclosures include:

- (a) How management identifies transactions, other events and conditions that may give rise to the need for, or changes in, accounting estimates and related disclosures.
- (b) Risks of material misstatement.
- (c) The relative materiality of the accounting estimates to the financial report as a whole;
- (d) Management's understanding (or lack thereof) regarding the nature and extent of, and the risks associated with, accounting estimates;
- (e) Whether management has applied appropriate specialised skills or knowledge or engaged appropriate experts.
- (f) The auditor's views about differences between the auditor's point estimate or range and management's point estimate.
- (g) The auditor's views about the appropriateness of the selection of accounting policies related to accounting estimates and presentation of accounting estimates in the financial report.
- (h) Indicators of possible management bias.
- (i) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates
- (j) When there has been a change from the prior period in the methods for making the accounting estimate, why, as well as the outcome of accounting estimates in prior periods.
- (k) Whether management's methods for making the accounting estimates, including when management has used a model, are appropriate in the context of the measurement objectives, the nature, conditions and circumstances, and other requirements of the applicable financial reporting framework.
- (l) The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions;
- (m) Whether significant assumptions are consistent with each other and with those used in other accounting estimates, or with assumptions used in other areas of the entity's business activities.
- (n) When relevant to the appropriateness of the significant assumptions or the appropriate application of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so.
- (o) How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

- (p) Whether the data and significant assumptions used by management in making the accounting estimates are appropriate in the context of the applicable financial reporting framework.
- (q) The relevance and reliability of information obtained from an external information source.
- (r) Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to data obtained from an external information source or valuations performed by management or a management's expert.
- (s) Significant differences in judgements between the auditor and management or a management's expert regarding valuations.
- (t) The potential effects on the entity's financial report of material risks and exposures required to be disclosed in the financial report, including the estimation uncertainty associated with accounting estimates.
- (u) The reasonableness of disclosures about estimation uncertainty in the financial report.
- (v) Whether management's decisions relating to the recognition, measurement, presentation and disclosure of the accounting estimates and related disclosures in the financial report are in accordance with the applicable financial reporting framework.

EXPOSURE DRAFT

ED 04/18

(August 2018)

Proposed Auditing Standard ASA 2018-2 *Amendments to Australian Auditing Standards*

Issued for Comment by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be received by no later than 15 October 2018. Comments should be addressed to:

The Chair
Auditing and Assurance Standards Board
PO Box 204, Collins Street West
Melbourne Victoria 8007 AUSTRALIA

Formal Submissions

Submissions should be lodged online via the “Work in Progress-Open for Comment” page of the Auditing and Assurance Standards Board (AUASB) website (www.auasb.gov.au/Work-In-Progress/Open-for-comment.aspx) as a PDF document and Word document.

A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AUASB website: www.auasb.gov.au

Contact Details

Auditing and Assurance Standards Board
Podium Level 14, 530 Collins Street
Melbourne Victoria 3000
AUSTRALIA

Phone: (03) 8080 7400
E-mail: enquiries@auasb.gov.au

Postal Address:
PO Box 204, Collins Street West
Melbourne Victoria 8007
AUSTRALIA

COPYRIGHT

© 2018 Auditing and Assurance Standards Board (AUASB). The text, graphics and layout of this Exposure Draft are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source as being the AUASB.

Requests and enquiries concerning reproduction and rights for commercial purposes should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Otherwise, no part of this Exposure Draft may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

This Exposure Draft reproduces substantial parts of the corresponding International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB) and published by the International Federation of Accountants (IFAC), in the manner described in the statement on Conformity with International Standards on Auditing. The AUASB acknowledges that IFAC is the owner of copyright in the International Standard on Auditing incorporated in this Exposure Draft throughout the world.

All existing rights in this material are reserved outside Australia. Reproduction outside Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use only.

Further information and requests for authorisation to reproduce this Exposure Draft for commercial purposes outside Australia should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Any decision to approve a request may also require the agreement of IFAC.

ISSN 1030-603X

CONTENTS

PREFACE

AUTHORITY STATEMENT

CONFORMITY WITH INTERNATIONAL STANDARDS ON AUDITING

	<i>Paragraphs</i>
Application	1-2
Operative Date	3
Introduction	
Scope of this Auditing Standard	4
Objective	5
Definition	6
Amendments to Auditing Standards	
Amendments to ASA 200	7
Amendments to ASA 230	8-10
Amendments to ASA 240	11-12
Amendments to ASA 260	13-18
Amendments to ASA 500	19-38
Amendments to ASA 580	39-40
Amendments to ASA 700	41
Amendments to ASA 701	42-45

PREFACE

Reasons for Issuing ED 04/18

The AUASB issues exposure draft ED 04/18 of proposed Auditing Standard ASA 2018-2 *Amendments to Australian Auditing Standards* pursuant to the requirements of the legislative provisions and the Strategic Direction explained below.

The AUASB is a non corporate Commonwealth entity of the Australian Government established under section 227A of the *Australian Securities and Investments Commission Act 2001*, as amended (ASIC Act). Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislation Act 2003*.

Under the Strategic Direction given to the AUASB by the Financial Reporting Council (FRC), the AUASB is required, inter alia, to develop auditing standards that have a clear public interest focus and are of the highest quality. Under the Strategic Direction, the AUASB is required to have regard to any programme initiated by the IAASB for the revision and enhancement of the International Standards on Auditing (ISAs) and to make appropriate consequential amendments to the Australian Auditing Standards.

Main Proposals

This proposed Auditing Standard makes amendments to the requirements and/or application and other explanatory material and/or appendices of the following Auditing Standards:

ASA 200	<i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards</i> (Issued October 2009 and amended to December 2015)
ASA 230	<i>Audit Documentation</i> (Issued October 2009 and amended to December 2015)
ASA 240	<i>The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report</i> (Issued October 2009 and amended to May 2017)
ASA 260	<i>Communication With Those Charged with Governance</i> (Issued December 2015 and amended to May 2017)
ASA 500	<i>Audit Evidence</i> (Issued October 2009 and amended to May 2017)
ASA 580	<i>Written Representations</i> (Issued October 2009 and amended to December 2015)
ASA 700	<i>Forming an Opinion and Reporting on a Financial Report</i> (Issued December 2015 and amended to May 2017)
ASA 701	<i>Communicating Key Audit Matters in the Independent Auditor's Report</i> (Issued December 2015 and amended to May 2017).

The amendments arise from changes made by the International Auditing and Assurance Standards Board (IAASB) to ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*.

For background to, and explanation of, the conforming and consequential amendments proposed in ED 04/18, refer to Explanatory Memorandum *Exposure Draft 03/18: Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures*; and *Exposure Draft 04/18: Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards*.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 15 December 2019.

Request for Comments

Comments are invited on this Exposure Draft of the proposed issuance of ASA 2018-2 *Amendments to Australian Auditing Standards* by no later than 15 October 2018. The AUASB is seeking comments from respondents on the following questions:

1. Have applicable laws and regulations been appropriately addressed in the proposed standard? Are there any references to relevant laws or regulations that have been omitted?
2. Whether there are any laws or regulations that may, or do, prevent or impede the application of the proposed standards, or may conflict with the proposed standards?
3. What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the main changes to the requirements of the proposed standards? If significant costs are expected, the AUASB would like to understand:
 - (a) Where those costs are likely to occur;
 - (b) The estimated extent of costs, in percentage terms (relative to audit fee); and
 - (c) Whether expected costs outweigh the benefits to the users of audit services?
4. Are there any other significant public interest matters that constituents wish to raise?

The AUASB prefers that respondents express a clear opinion on whether they support the proposed amendments and that this opinion be supplemented by detailed comments, whether supportive or critical, on the above matters. The AUASB regards both supportive and critical comments as essential to a balanced review of the proposed Auditing Standard.

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes this Auditing Standard ASA 2018-2 *Amendments to Australian Auditing Standards* pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001* and section 336 of the *Corporations Act 2001*.

Conformity with International Standards on Auditing

This Auditing Standard has been made for Australian legislative purposes. It contains a series of proposed miscellaneous amendments to various Australian Auditing Standards (as shown) arising from the proposed revision of an existing Auditing Standard. The proposed amendments, in the main, reflect similar amendments made to the equivalent International Standard on Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board of the International Federation of Accountants (IFAC).

AUDITING STANDARD ASA 2018-2

Amendments to Australian Auditing Standards

Application

1. This Auditing Standard applies to:
 - (a) an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with the *Corporations Act 2001*; and
 - (b) an audit of a financial report, or a complete set of financial statements, for any other purpose.
2. This Auditing Standard also applies, as appropriate, to an audit of other historical financial information.

Operative Date

3. This Auditing Standard is operative for financial reporting periods commencing on or after 15 December 2019.

Introduction

Scope of this Auditing Standard

4. This Auditing Standard makes amendments to Australian Auditing Standards. The amendments arise from consequential and conforming changes arising from the issuance of ASA 540 *Auditing Accounting Estimates and Related Disclosures*.

Objective

5. The objective of this Auditing Standard is to make amendments to the following Auditing Standards:
 - (a) *ASA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* (Issued October 2009 and amended to December 2015)
 - (b) *ASA 230 Audit Documentation* (Issued October 2009 and amended to December 2015)
 - (c) *ASA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* (Issued October 2009 and amended to May 2017)
 - (d) *ASA 260 Communication With Those Charged with Governance* (Issued December 2015 and amended to May 2017)
 - (e) *ASA 500 Audit Evidence* (Issued October 2009 and amended to May 2017)
 - (f) *ASA 580 Written Representations* (Issued October 2009 and amended to December 2015)
 - (g) *ASA 700 Forming an Opinion and Reporting on a Financial Report* (Issued December 2015 and amended to May 2017)
 - (h) *ASA 701 Communicating Key Audit Matters in the Independent Auditor's Report* (Issued December 2015 and amended to May 2017).

Definition

6. For the purposes of this Auditing Standard, the meanings of terms are set out in each Auditing Standard and in the *AUASB Glossary*.

Amendments to Auditing Standards

Amendments to ASA 200

7. Existing paragraph A42 is amended (including the insertion of new footnotes, * and ^) to read follows:

The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made. The Australian Auditing Standards do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement.” However, ASA 540* requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, for accounting estimates at the assertion level in accordance with ASA 330. In identifying and assessing risks of material misstatement for significant classes of transactions, account balances or disclosures other than accounting estimates, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. ~~The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.~~

* See ASA 540 *Auditing Accounting Estimates and Disclosures*, paragraph 15.

^ See ASA 330, paragraph 7(b).

Amendments to ASA 230

8. Existing paragraph A7 is amended to read as follows:

Audit documentation provides evidence that the audit complies with the Australian Auditing Standards. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgement made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management or, where appropriate, those charged with governance.
- An auditor’s report containing an appropriately qualified opinion on the financial report demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the Australian Auditing Standards.
- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:

- For example, there may be no single way in which the auditor's professional scepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional scepticism in accordance with the Australian Auditing Standards. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, documenting how the auditor evaluated that evidence, including the professional judgements made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's enquiries.
- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the Australian Auditing Standards may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussions required by ASA 315.⁵

9. Existing paragraph A10 is amended to read as follows:

Some examples of circumstances in which, in accordance with paragraph 8, it is appropriate to prepare audit documentation relating to the use of professional judgement include, where the matters and judgements are significant:

- The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgements made by management ~~(for example, the reasonableness of significant accounting estimates).~~
- The basis for the auditor's evaluation of whether an accounting estimate and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.
- When ASA 701 applies,⁷ the auditor's determination of the key audit matters or the determination that there are no key audit matters to be communicated.

Amendments to ASA 230 Appendix 1

10. The eleventh point is amended to read as follows:

- *ASA 540 Auditing Accounting Estimates, ~~Including Fair Value Accounting Estimates, and Related Disclosures~~ – paragraph ~~37~~²³*

Amendments to ASA 240

11. Existing paragraph A48 is amended to read as follows:

A retrospective review is also required by ASA 540.²⁰ That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's previous prior period estimation process accounting estimates, audit evidence about the outcome, or where applicable, their subsequent re-estimation of prior period accounting estimates that is pertinent to making to assist in identifying and assessing the risks of material misstatement in the current period accounting estimates, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial report. As a practical matter, the auditor's review of management judgements and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this Auditing Standard may be carried out in conjunction with the review required by ASA 540.

12. Existing footnote 20 is amended to read as follows:

See ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 14 9.

Amendments to ASA 260

13. Existing paragraph A19 is amended to read as follows:

Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgements about accounting policies and financial report disclosures, for example, in relation to the use of key assumptions in the development of accounting estimates ~~for which there is significant measurement uncertainty~~. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information to users about the most difficult, subjective or complex judgements made by management in preparing the financial report.

14. Existing paragraph A20 is amended to read as follows:

As a result, the auditor's views on the subjective aspects of the financial report may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor's ~~evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks~~. views on the degree to which complexity, subjectivity or other inherent risk factors affect the selection or application of the methods, assumptions and data used in making a significant accounting estimate, as well as the auditor's evaluation of whether management's point estimate and related disclosures in the financial report are reasonable in the context of the applicable financial reporting framework. Open and constructive communication about significant qualitative aspects of the entity's accounting practices also may include comment on the acceptability of significant accounting practices and on the quality of the disclosures. When applicable, this may include whether a significant accounting practice of the entity relating to accounting estimates is considered by the auditor not to be most appropriate to the particular circumstances of the entity, for example, when an alternative acceptable method for making an accounting estimate would, in the auditor's judgement, be more appropriate. Appendix 2 identifies matters that may be included in this communication.

Amendments to ASA 260 Appendix 1

15. After the existing seventh point, the following point is inserted as follows:

- ASA 540 Auditing Accounting Estimates and Related Disclosures – paragraph 36

Amendments to ASA 260 Appendix 2

16. The heading *Accounting Estimates* is amended to read as follows:

Accounting Estimates and Related Disclosures

17. Under the existing heading *Accounting Estimates*, the following amendments are made:

- ~~For items for which estimates are significant, issues discussed in ASA 540,29 including, for example: Appendix 2 of ASA 540 includes matters that the auditor may consider communicating with respect to significant qualitative aspects of the entity's accounting practices related to accounting estimates and related disclosures.~~
- ~~How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial report.~~
- ~~Changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.~~
- ~~Whether management's decision to recognise, or to not recognise, the accounting estimates in the financial report is in accordance with the applicable financial reporting framework.~~
- ~~Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates and, if so, why, as well as the outcome of accounting estimates in prior periods.~~
- ~~Management's process for making accounting estimates (e.g., when management has used a model), including whether the selected measurement basis for the accounting estimate is in accordance with the applicable financial reporting framework.~~
- ~~Whether the significant assumptions used by management in developing the accounting estimate are reasonable.~~
- ~~Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.~~
- ~~Risks of material misstatement.~~
- ~~Indicators of possible management bias.~~
- ~~How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.~~
- ~~The adequacy of disclosure of estimation uncertainty in the financial report.~~

18. Existing footnote 29 to Appendix 2 is deleted.

Amendments to ASA 500

19. The following sub-paragraph (including footnotes, * and ^) is inserted following existing sub-paragraph 5(c):

External information source means an external individual or organisation that provides information that has been used by the entity in preparing the financial report, or that has been obtained by the auditor as audit evidence, when such information is suitable for use by a broad range of users. When information has been provided by an individual or organisation acting in the capacity of a management's expert, service organisation*, or auditor's expert^ the individual or organisation is not considered an external information source with respect to that particular information. (Ref: Para. A1A-A1C)

* See ASA 402 *Audit Considerations Relating to an Entity Using a Service Organisation*, paragraph 8.

^ See ASA 620 *Using the Work of an Auditor's Expert*, paragraph 6.

20. Existing paragraph 7 is amended to read as follows:

When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence-, including information obtained from an external information source. (Ref: Para. A26-A34)

21. Following the heading *Application and Other Explanatory Material*, and before the sub-heading *Sufficient Appropriate Audit Evidence* the following sub-heading is inserted:

External Information Source (Ref: Para. 5(cA))

22. Following the sub-heading inserted above, the following paragraph is inserted:

External information sources may include pricing services, governmental organisations, central banks or recognised stock exchanges. Examples of information that may be obtained from external information sources include:

- Prices and pricing related data;
- Macro-economic data, such as historical and forecast unemployment rates and economic growth rates, or census data;
- Credit history data;
- Industry specific data, such as an index of reclamation costs for certain extractive industries, or viewership information or ratings used to determine advertising revenue in the entertainment industry; and
- Mortality tables used to determine liabilities in the life insurance and superannuation sectors.

23. Following the paragraph inserted above, the following paragraph is inserted:

A particular set of information is more likely to be suitable for use by a broad range of users and less likely to be subject to influence by any particular user if the external individual or organisation provides it to the public for free, or makes it available to a wide range of users in return for payment of a fee. Judgement may be required in determining whether the information is suitable for use by a broad range of users, taking into account the ability of the entity to influence the external information source.

24. The following paragraph is inserted following the above insertions:

An external individual or organisation cannot, in respect of any particular set of information, be both an external information source and a management's expert, or service organisation or auditor's expert.

25. The following paragraph (including a footnote *) is inserted following the above insertions:

However, an external individual or organisation may, for example, be acting as a management's expert when providing a particular set of information, but may be acting as an external information source when providing a different set of information. In some circumstances, professional judgement may be needed to determine whether an external individual or organisation is acting as an external information source or as a management's expert with respect to a particular set of information. In other circumstances, the distinction may be clear. For example:

- An external individual or organisation may be providing information about real estate prices that is suitable for use by a broad range of users, for example, information made generally available pertaining to a geographical region, and be determined to be an external information source with respect to that set of information. The same external organisation may also be acting as a management's or auditor's expert in providing commissioned valuations, with respect to the entity's real estate portfolio specifically tailored for the entity's facts and circumstances.
- Some actuarial organisations publish mortality tables for general use which, when used by an entity, would generally be considered to be information from an external information source. The same actuarial organisation may also be a management's expert with respect to different information tailored to the specific circumstances of the entity to help management determine the superannuation liability for several of the entity's superannuation plans.
- An external individual or organisation may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the external individual or organisation applies that expertise in making an estimate specifically for the entity and that work is used by management in preparing its financial report, the external individual or organisation is likely to be a management's expert with respect to that information. If, on the other hand, that external individual or organisation merely provides, to the public, prices or pricing-related data regarding private transactions, and the entity uses that information in its own estimation methods, the external individual or organisation is likely to be an external information source with respect to such information.
- An external individual or organisation may publish information, suitable for a broad range of users, about risks or conditions in an industry. If used by an entity in preparing its risk disclosures (for example in compliance with AASB 7*), such information would ordinarily be considered to be information from an external information source. However, if the same type of information has been specifically commissioned by the entity to use its expertise to develop information about those risks, tailored to the entity's circumstances, the external individual or organisation is likely to be acting as a management's expert.

- An external individual or organisation may apply its expertise in providing information about current and future market trends, which it makes available to, and is suitable for use by, a broad range of users. If used by the entity to help make decisions about assumptions to be used in making accounting estimates, such information is likely to be considered to be information from an external information source. If the same type of information has been commissioned by the entity to address current and future trends relevant to the entity's specific facts and circumstances, the external individual or organisation is likely to be acting as a management's expert.

* Accounting Standard AASB 7 *Financial Instruments: Disclosures*

26. Existing paragraph A1 is amended to read as follows:

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit)⁶ or a firm's quality control procedures for client acceptance and continuance. ~~In addition to other sources inside and outside the entity,~~ the entity's accounting records and other sources internal to the entity are an important source of audit evidence. ~~Also, information that may be used as audit evidence may have been prepared using the work of a management's expert, or be obtained from an external information source.~~ Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

27. Existing paragraph A9 is amended to read as follows:

Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, and information from an external information source, including analysts' reports, and comparable data about competitors (benchmarking data).

28. Existing paragraph A31 is amended to read as follows:

The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, ~~information obtained from an source independent external source of the entity~~ may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- ...
- ...

29. Following existing paragraph A34 the following sub-heading is inserted:

External Information Sources

30. The following paragraph (including a footnote *) is inserted following the above sub-heading:

The auditor is required by paragraph 7 to consider the relevance and reliability of information obtained from an external information source that is to be used as audit evidence, regardless of whether that information has been used by the entity in preparing the financial report or obtained by the auditor. For information obtained from an external information source, that consideration may, in certain cases, include audit evidence about the external information source or the preparation of the information by the external information source, obtained through designing and performing further audit procedures in accordance with ASA 330 or, where applicable, ASA 540.*

* See ASA 540 *Auditing Accounting Estimates and Disclosures*

31. The following paragraph is inserted following the above insertion:

Obtaining an understanding of why management or, when applicable, a management's expert uses an external information source, and how the relevance and reliability of the information was considered (including its accuracy and completeness), may help to inform the auditor's consideration of the relevance and reliability of that information.

32. The following paragraph is inserted following the above insertions:

The following factors may be important when considering the relevance and reliability of information obtained from an external information source, including its accuracy and completeness, taking into account that some of these factors may only be relevant when the information has been used by management in preparing the financial report or has been obtained by the auditor:

- The nature and authority of the external information source. For example, a central bank or government statistics office with a legislative mandate to provide industry information to the public is likely to be an authority for certain types of information;
- The ability to influence the information obtained, through relationships between the entity and the information source;
- The competence and reputation of the external information source with respect to the information, including whether, in the auditor's professional judgement, the information is routinely provided by a source with a track record of providing reliable information;
- Past experience of the auditor with the reliability of the information provided by the external information source;
- Evidence of general market acceptance by users of the relevance and/or reliability of information from an external information source for a similar purpose to that for which the information has been used by management or the auditor;
- Whether the entity has in place controls to address the relevance and reliability of the information obtained and used;
- Whether the external information source accumulates overall market information or engages directly in "setting" market transactions;
- Whether the information is suitable for use in the manner in which it is being used and, if applicable, was developed taking into account the applicable financial reporting framework;
- Alternative information that may contradict the information used;

- The nature and extent of disclaimers or other restrictive language relating to the information obtained;
- Information about the methods used in preparing the information, how the methods are being applied including, where applicable, how models have been used in such application, and the controls over the methods; and
- When available, information relevant to considering the appropriateness of assumptions and other data applied by the external information sources in developing the information obtained.

33. The following paragraph (including a footnotes, * and ^) is inserted following the above insertions:

The nature and extent of the auditor's consideration takes into account the assessed risks of material misstatement at the assertion level to which the use of the external information is relevant, the degree to which the use of that information is relevant to the reasons for the assessed risks of material misstatement and the possibility that the information from the external information source may not be reliable (for example, whether it is from a credible source). Based on the auditor's consideration of the matters described in paragraph A33B, the auditor may determine that further understanding of the entity and its environment, including its internal control, is needed, in accordance with ASA 315, or that further audit procedures, in accordance with ASA 330*, and ASA 540^ when applicable, are appropriate in the circumstances, to respond to the assessed risks of material misstatement related to the use of information from an external information source. Such procedures may include:

- Performing a comparison of information obtained from the external information source with information obtained from an alternative independent information source.
- When relevant to considering management's use of an external information source, obtaining an understanding of controls management has in place to consider the reliability of the information from external information sources, and potentially testing the operating effectiveness of such controls.
- Performing procedures to obtain information from the external information source to understand its processes, techniques, and assumptions, for the purposes of identifying, understanding and, when relevant, testing the operating effectiveness of its controls.

* See ASA 330, paragraph 6.

^ See ASA 540, paragraph 29.

34. The following paragraph is inserted following the above insertions:

In some situations, there may be only one provider of certain information, for example, information from a central bank or government, such as an inflation rate, or a single recognised industry body. In such cases, the auditor's determination of the nature and extent of audit procedures that may be appropriate in the circumstances is influenced by the nature and credibility of the source of the information, the assessed risks of material misstatement to which that external information is relevant, and the degree to which the use of that information is relevant to the reasons for the assessed risk of material misstatement. For example, when the information is from a credible authoritative source, the extent of the auditor's further audit procedures may be less extensive, such as corroborating the information to the source's website or published information. In other cases, if a source is not assessed as credible, the auditor may determine that more extensive procedures are appropriate and, in the absence of any alternative independent information source against which to compare, may consider whether performing procedures to obtain information from the external information source, when practical, is appropriate in order to obtain sufficient appropriate audit evidence.

35. The following paragraph (including a footnote *) is inserted following the above insertions:

When the auditor does not have a sufficient basis with which to consider the relevance and reliability of information from an external information source, the auditor may have a limitation on scope if sufficient appropriate audit evidence cannot be obtained through alternative procedures. Any imposed limitation on scope is evaluated in accordance with the requirements of ASA 705.

* See ASA 705 *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 13.

36. Existing paragraph A36 is amended to read as follows:

When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 applies. For example, an individual or organisation may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organisation applies that expertise in making an estimate which the entity uses in preparing its financial report, the individual or organisation is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organisation merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this Auditing Standard, but is being information from an external information source and not the use of a management's expert by the entity.

37. Existing footnote 16 to paragraph A45 is amended to read as follows:

See ASA 620 ~~*Using the Work of an Auditor's Expert*~~, paragraph 7.

38. Existing paragraph A49 is amended to read as follows:

Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial report;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; ~~and~~
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data; ~~and~~
- If that expert's work involves the use of information from an external information source, the relevance and reliability of that information.

Amendments to ASA 580

Amendments to ASA 580 Appendix 1

39. The fifth point is amended to read as follows:

- ~~ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* – paragraph 22~~35

Amendments to ASA 580 Appendix 2

40. The second point following the heading *Financial Report of the Illustrative Representation Letter* is amended to read as follows:
- ~~Significant~~ The methods, the data, and the significant assumptions used by us in making accounting estimates, including those measured at fair value, and their related disclosures are appropriate to achieve recognition, measurement or disclosure that is reasonable in the context of the applicable financial reporting framework. (ASA 540)

Amendments to ASA 700

41. Existing paragraph 13 is amended to read as follows:
- In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:
- (a) ...
 - (b) ...
 - (c) The accounting estimates and related disclosures made by management are reasonable;
 - (d) ...

Amendments to ASA 701

42. Existing paragraph 9 is amended to read as follows:
- The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9- A18)
- (a) ...
 - (b) Significant auditor judgements relating to areas in the financial report that involved significant management judgement, including accounting estimates that ~~have been identified as having~~ are subject to a high degree of estimation uncertainty. (Ref: Para. A23-A24)
 - (c) ...
43. The existing sub-heading following paragraph A22 is amended to read as follows:
- ~~Significant Auditor Judgements Relating to Areas in the Financial Report that Involved Significant Management Judgement, Including Accounting Estimates that Have Been Identified as Having~~ Are Subject to a High Degree of Estimation Uncertainty (Ref: Para. 9(b))
44. Existing paragraph A24 is amended to read as follows:
- However, users of the financial report have highlighted their interest in accounting estimates that ~~have been identified as having~~ are subject to a high degree of estimation uncertainty in accordance with (see ASA 540²⁸) that may have not been determined to be significant risks. Among other things, such estimates are highly dependent on management judgement and are often the most complex areas of the financial report, and may require the involvement of both a management's expert and an auditor's expert. Users have also highlighted that accounting policies that have a significant effect on the financial report (and significant changes to those policies) are relevant to their understanding of the financial report, especially in circumstances where an entity's practices are not consistent with others in its industry.

45. Existing footnote 28 to paragraph A24 is amended to read as follows:

See ASA 540 *Auditing Accounting Estimates, ~~Including Fair Value Accounting Estimates,~~ and Related Disclosures*, paragraphs ~~1510-11~~.

August 2018

Explanatory Memorandum
Exposure Draft 03/18: Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures; and Exposure Draft 04/18: Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards

Issued by the Auditing and Assurance Standards Board



Australian Government

Auditing and Assurance Standards Board

Obtaining a Copy of this Explanatory Memorandum

This Explanatory Memorandum is available on the Auditing and Assurance Standards Board (AUASB) website: www.auasb.gov.au

Contact Details

Auditing and Assurance Standards Board
Podium Level 14, 530 Collins Street
Melbourne Victoria 3000 AUSTRALIA

Phone: (03) 8080 7400
Fax: (03) 8080 7450
E-mail: enquiries@auasb.gov.au

Postal Address:
PO Box 204, Collins Street West
Melbourne Victoria 8007 AUSTRALIA

COPYRIGHT

© 2018 Auditing and Assurance Standards Board (AUASB). The text, graphics and layout of this document are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source as being the AUASB.

Requests and enquiries concerning reproduction and rights for commercial purposes should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Otherwise, no part of this document may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

ISSN 2201-3644

Important Note and Disclaimer

This Explanatory Memorandum is issued by the AUASB to provide information to auditors and assurance practitioners about the AUASB's implementation in Australia of the IAASB's revised ISA 540 *Auditing Accounting Estimates and Related Disclosures* as well as consequential and conforming changes arising from the proposed revision.

This Explanatory Memorandum does not establish or extend the requirements under an existing AUASB Standard(s) and is not intended to be a substitute for compliance with the relevant AUASB Standards with which auditors and assurance practitioners are required to comply when conducting an audit or other assurance engagement. No responsibility is taken for the results of actions or omissions to act on the basis of any information contained in this document or for any errors or omissions in it.

CONTENTS

	<i>Paragraph</i>
Purpose	1
Exposure Draft Questions	2
Background	
IAASB.....	3-8
AUASB	9-18
Other Outreach Activities.....	19
Application	20-21
Website Resources	22

EXPLANATORY MEMORANDUM

Exposure Draft 03/18: Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures; and Exposure Draft 04/18: Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards

Purpose

1. The aim of this Explanatory Memorandum is to provide constituents with information about Exposure Draft ED 03/18 and Exposure Draft ED 04/18, issued on 6 August 2018, and the Auditing and Assurance Standards Board's (AUASB) approach to implementing in Australia, the IAASB's ISA 540 *Auditing Accounting Estimates and Related Disclosures* (ISA 540), as well as consequential and conforming changes arising from the proposed revision.

Exposure Draft Questions

2. The AUASB is especially interested in constituents' views on:
 - (a) Have applicable laws and regulations been appropriately addressed in the proposed standard? Are there any references to relevant laws or regulations that have been omitted?
 - (b) Whether there are any laws or regulations that may, or do, prevent or impede the application of the proposed standards, or may conflict with the proposed standards?
 - (c) What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the main changes to the requirements of the proposed standards? If significant costs are expected, the AUASB would like to understand:
 - (i) Where those costs are likely to occur;
 - (ii) The estimated extent of costs, in percentage terms (relative to audit fee); and
 - (iii) Whether expected costs outweigh the benefits to the users of audit services?
 - (d) What, if any, implementation guidance auditors, preparers and other stakeholders would like the AUASB to issue in conjunction with the release of ASA 540 (specific questions/examples would be helpful).
 - (e) Are there any other significant public interest matters that constituents wish to raise?

Background

IAASB

3. Developments in business environments, technology and financial instruments since extant ISA 540 became effective have given rise to new audit challenges. Further, an increasing use of estimates in preparing financial statements has increased the importance that users place on disclosures related to accounting estimates. Accordingly, the IAASB set out to develop a revised ISA 540 *Auditing Accounting Estimates and Related Disclosures*.

4. In April 2017, the IAASB issued Exposure Draft Proposed International Standard on Auditing 540 *Auditing Accounting Estimates and Related Disclosures*, with the objective of ISA 540 being for the auditor to obtain sufficient appropriate audit evidence to evaluate whether accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. There were 68 responses to the IAASB's exposure draft with general support for the objectives of the revision, but with concerns expressed regarding, inter-alia, scalability, complexity and the compartmentalisation of audit effort into three risk factors of estimation uncertainty, judgement and complexity.
5. Over the past 15 months, the IAASB have sought to address the concerns raised by respondents. On 22 June 2018, the IAASB approved ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* and related conforming amendments to other ISAs. This is subject to approval by the Public Interest Oversight Board (PIOB) in September 2018 to confirm that due process has been followed with proper regard to the public interest.
6. As described in paragraph 14 below, the AUASB now issues ED 03/18 *Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures* (ED 03/18) and ED 04/18 *Proposed Auditing Standard 2018-2 Amendments to Australian Auditing Standards* (ED 04/18).
7. Given the concerns raised through the IAASB exposure process, and the consequential amendments, we outline here the major revisions from the extant ASA 540:
 - (a) *Use of the term 'reasonable' for disclosures*

ED 03/18, paragraph 11 includes the objective that related accounting disclosures should be 'reasonable' in the context of the financial reporting framework. This is a change from the extant ASA 540 paragraph 6(b), in that the extant uses the term 'adequate' when related to disclosures.
 - (b) *Scalability*

While involving a step up in work effort, especially in the area of complex estimates, ED 03/18 considers and facilitates scalability, recognizing that the standard applies to all accounting estimates. Scalability is reinforced in the following ways:

 - (i) emphasis and detailed description of the concept of a spectrum of inherent risks
 - (ii) use of wording that indicates conditionality
 - (iii) emphasis that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be.
 - (c) *Professional scepticism*

Professional scepticism plays a central role in the audit of accounting estimates. ED 03/18 contains several key provisions that are designed to enhance the auditor's application of professional scepticism and consideration of the potential for management bias, including:

 - (i) enhanced risk assessment requirements
 - (ii) more prescriptive requirements with respect to obtaining audit evidence and clarification that audit evidence should be obtained in a manner that is unbiased as to whether evidence is corroborative or contradictory
 - (iii) a requirement to "stand back" and evaluate the audit evidence obtained
 - (iv) use of stronger terminology in application material such as 'question' or 'challenge'
 - (d) *Risk assessment:*

Risk assessment requirements in ED 03/18 are more specific than the extant ASA 540 to address the auditing challenges in an increasingly complex business and financial reporting environment. Enhanced requirements and application material to address risk assessment include:

- (i) a requirement, ED 03/18 paragraph 16, to make a separate assessment of inherent risk and control risk in order to drive a focus on consideration of inherent risk factors in identification and assessment of risk of material misstatement. This differs to ASA 200 paragraph A42 where the auditor may make separate or combined assessments, but aligns with ED 01/18 proposed ASA 315, which requires separate assessment of inherent risk and control risk.
 - (ii) the introduction of inherent risk factors for consideration, ED 03/18 paragraph 16, of estimation uncertainty, complexity, subjectivity and other inherent risk factors.
 - (iii) a requirement, ED 03/18 paragraph 17, that where a significant risk is identified, the auditor is required to obtain an understanding of the entity's controls relevant to that risk.
- (e) *Responses to assessed risk of material misstatement*
- (i) ED 03/18 includes objectives-based requirements for each testing strategy based around methods, assumptions and data while considering inherent risk factors
 - (ii) enhanced requirements, in ED 03/18 paragraphs 27-29, where management has not adequately addressed estimation uncertainty
 - (iii) emphasises when tests of controls are required, in ED 03/18 paragraphs 19-20, including improved cross-referencing to ASA 315 and ASA 330.
- (f) *Documentation:*
- Expanded requirements, ED 03/18 paragraph 39, to include more specific documentation requirements for accounting estimates.

8. The conforming and consequential amendments arising from ED 03/18 are reflected in ED 04/18 *Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards* (ED 04/18). The most significant conforming and consequential amendments arising in ED 04/18 are in the following areas:

- (a) ASA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* - including identifying in the application material that ED 03/18 ASA 540 requires a separate assessment of inherent risk and control risk.
- (b) ASA 230, *Audit Documentation* - including identifying in the application material that documentation providing evidence of the auditor's exercise of professional scepticism may include documenting how the auditor evaluated evidence obtained that both corroborates and contradicts management's assertions. It also identifies that examples of documentation of significant professional judgments include the basis for the auditor's evaluation of whether an accounting estimate and related disclosures are reasonable in the context of the applicable financial reporting framework.
- (c) ASA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* - amending the application material to be clear that a retrospective review is not necessarily restricted to the prior period.
- (d) ASA 260, *Communication with Those Charged with Governance* – including identifying in the application material that those charged with governance may be interested in the auditor's views on the degree to which complexity, subjectivity or other inherent risk factors affect the selection or application of the methods,

assumptions and data used in making a significant accounting estimate, as well as the auditor's evaluation of whether management's point estimate and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework; and, when applicable, whether a significant accounting practice of the entity relating to accounting estimates is considered by the auditor not to be most appropriate to the particular circumstances of the entity.

- (e) ASA 500, *Audit Evidence*, in relation to "external information sources" - including a definition; amending the requirement in paragraph 7 to clarify that the auditor needs to consider the relevance and reliability of information to be used as audit evidence obtained from an external information source; and extensive additional application material.
 - (f) ASA 580, *Written Representations*, - amending the illustrative representation letter to align with the changes in ED 03/18 ASA 540.
 - (g) ASA 700, *Forming an Opinion and Reporting on a Financial Report* - amending the requirement in paragraph 13(c) to reflect that the auditor evaluates whether related disclosures, as well as the accounting estimates, made by management are reasonable.
 - (h) ASA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* - editorial changes to the requirement in paragraph 9 and related application material, including to reflect ED 03/18 ASA 540 references to a high "degree of" estimation uncertainty.
9. Further details can be found on the IAASB's website: <http://www.ifac.org/auditing-assurance>
- [IAASB Explanatory Memorandum and Exposure Draft ED ISA 540](#)
 - [ISA 540 Revised Auditing Accounting Estimates and Related Disclosures](#)
 - [Conforming and Consequential Amendments](#)

AUASB

10. In August 2017, the AUASB made a [written submission](#) to the IAASB in response to ED ISA 540. In formulating its response, the AUASB sought input from its constituents in three principal ways. The first was from hosting a roundtable meeting with stakeholders in three of the large Australian cities - stakeholders that represent a broad range of backgrounds including assurance providers from medium and large audit firms, audit regulators, professional accounting bodies, directors, preparers and users of financial statements. The second was through an open invitation to provide comments placed on the AUASB website. The third was by way of subsequent formal discussions by the AUASB members at recent board meetings.
11. The AUASB has closely followed the activities of the IAASB in their revisions to ED ISA 540 and consider that the majority of feedback generated by Australian constituents has been addressed in the final revised ISA 540.
12. In accordance with its mandates under section 227 of the *ASIC Act 2001* and the Financial Reporting Council's (FRC) Strategic Direction, the AUASB's policy is to adopt the IAASB's auditing standards (ISAs), unless there are compelling reasons not to do so; and to amend the ISAs only when there are compelling reasons to do so. The AUASB's principles of convergence with the ISAs and harmonisation with the New Zealand auditing standards can be found on the AUASB's website: http://www.auasb.gov.au/admin/file/content102/c3/Aug14_IAASB-NZAuASB_Principles_of_Convergence_and_Harmonisation.pdf
13. Compelling reasons fall broadly into two categories: legal and regulatory; and principles and practices considered appropriate in maintaining or improving audit quality in Australia. Compelling reasons are further guided by the AUASB's policy of harmonisation with the standards of the New Zealand Auditing and Assurance Standards Board (NZAuASB).

14. The AUASB has decided to adopt the revised ISA, relating to auditing accounting estimates and related disclosures and the related consequential and conforming amendments, into the Australian Auditing Standards that are made under section 336 of the *Corporations Act 2001*. Prior to implementation, the AUASB is required to consult with constituents and accordingly now issues Exposure Draft ED 03/18 and Exposure Draft ED 04/18 for public exposure and comment. All comments received from constituents are considered by the AUASB prior to finalisation of the proposed revised standard.

Exposure Draft Protocols

15. Under its convergence policies, the AUASB continues to include requirements and guidance that are in addition to, or a clarification of, the equivalent ISA only when the compelling reason test have been met. Any such modifications continue to be identified in the Australian Auditing Standards by paragraph numbering commencing with an “Aus” prefix. Any such changes do not diminish the requirements of the equivalent ISA.
16. In addition to those changes that meet the compelling reason test, the AUASB makes format and terminology changes to comply with requirements relating primarily to legislative instruments. Such changes are machinery in nature and do not change the meaning of the equivalent ISA.

AUASB Modifications to the ISA

17. In line with the AUASB’s policy of convergence with the standards of the IAASB (see link at paragraph 12 above), the AUASB does not propose any modification to ISA 540 Revised and the related consequential and conforming amendments.

General

18. ED 03/18 and ED 04/18 will be open to constituents for a **70 day comment period**.
19. At the completion of the exposure period, the AUASB will consider constituents’ submissions and where the AUASB determines that compelling reason exist, amendments to the exposure drafts will be made.

Other Outreach Activities

20. In addition to the public exposure process, the AUASB intends to conduct roundtable consultative meetings and a webinar, in conjunction with the AUASB exposure draft ED 01/18 Proposed ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

Application

21. The revised standard will be applicable for financial reporting periods **beginning on or after 15 December 2019**. This application date corresponds with that of the equivalent ISA.

Early Adoption

22. Consistent with the IAASB’s policy, all Australian Auditing Standards may be early adopted unless explicitly prohibited.

Website Resources

23. The AUASB welcomes constituents’ input to the development of Australian Auditing Standards and regards both supportive and critical comments as essential to a balanced review of the proposed standards. Constituents are encouraged to access the websites of the [AUASB](#) and the [IAASB](#) to obtain further information.

* *