

Sinhala and Tamil versions of this *Gazette* extraordinary will be published separately.



ශ්‍රී ලංකා ප්‍රජාතාන්ත්‍රික සමාජවාදී ජනරජයේ ගැසට් පත්‍රය

අති විශේෂ

The Gazette of the Democratic Socialist Republic of Sri Lanka EXTRAORDINARY

අංක 1904/01 - 2015 මාර්තු මස 02 වැනි සඳුදා - 2015.03.02

No. 1904/01 - MONDAY, MARCH 02, 2015

(Published by Authority)

PART I : SECTION (I) — GENERAL

Government Notifications

SRI LANKA ACCOUNTING AND AUDITING STANDARDS ACT, No. 15 OF 1995

Publication under Section 4(2)

BY virtue of the powers vested in the Institute of Chartered Accountants of Sri Lanka (hereinafter referred to as the "Institute"), the Institute has adopted the Changes to Sri Lanka Auditing Standards with effect from 01 January 2015 published herewith for the purpose of the Sri Lanka Accounting and Auditing Standards, Act, No. 15 of 1995. This Standard shall be effective for financial statements covering period commencing on or after the first day of January Two Thousand Fifteen. Earlier application is permitted.

Further, hereby the document on the Gazette Notification on "Audit Report: As per SLAuS 700 -2014 with changes to Independent Auditor's Report" under the same *Extra Ordinary Gazette* Number would be withdrawn.

By Order of the Council,

ARUNA ALWIS,
Secretary.

The Institute of Chartered Accountants of Sri Lanka,
No. 30A,
Malalasekera Mawatha,
Colombo 07.
27th February, 2015



CHANGES TO SRI LANKA AUDITING STANDARDS WITH EFFECT FROM 01 JANUARY 2015

Glossary of Terms

SRI LANKA STANDARD ON QUALITY CONTROL (SLSQC)

Sri Lanka Standard on Quality Control (SLSQC) 1, Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements

AUDITS OF HISTORICAL FINANCIAL INFORMATION

200-299 GENERAL PRINCIPLES AND RESPONSIBILITIES

SLAuS 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in
Accordance with Sri Lanka Auditing Standards

SLAuS 210, Agreeing the Terms of Audit Engagements

SLAuS 220, Quality Control for an Audit of Financial Statements

SLAuS 230, Audit Documentation

SLAuS 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

SLAuS 250, Consideration of Laws and Regulations in an Audit of Financial Statements

SLAuS 260, Communication with Those Charged with Governance

SLAuS 265, Communicating Deficiencies in Internal Control to Those Charged with Governance
and Management

300-499 RISK ASSESSMENT AND RESPONSE TO ASSESSED RISKS

SLAuS 300, Planning an Audit of Financial Statements

SLAuS 315, Identifying and Assessing the Risks of Material Misstatement through
Understanding the Entity and Its Environment

SLAuS 320, Materiality in Planning and Performing an Audit

SLAuS 330, The Auditor's Responses to Assessed Risks

SLAuS 402, Audit Considerations Relating to an Entity Using a Service Organization

SLAuS 450, Evaluation of Misstatements Identified during the Audit

500-599 AUDIT EVIDENCE

SLAuS 500, Audit Evidence

SLAuS 501, Audit Evidence—Specific Considerations for Selected Items

SLAuS 505, External Confirmations

SLAuS 510, Initial Audit Engagements—Opening Balances

SLAuS 520, Analytical Procedures

SLAuS 530, Audit Sampling

SLAuS 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and
Related Disclosures

SLAuS 550, Related Parties

SLAuS 560, Subsequent Events

SLAuS 570, Going Concern

SLAuS 580, Written Representations

600-699 USING WORK OF OTHERS

SLAuS 600, Special Considerations—Audits of Group Financial Statements (Including the Work
of Component Auditors)

SLAuS 610, Using the Work of Internal Auditors

700-799 AUDIT CONCLUSIONS AND REPORTING

SLAuS 700, Forming an Opinion and Reporting on Financial Statements

SLAuS 705, Modifications to the Opinion in the Independent Auditor's Report

SLAuS 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's
Report

SLAuS 710, Comparative Information—Corresponding Figures and Comparative Financial Statements

SLAuS 720, The Auditor's Responsibilities Relating to Other Information in Documents Containing
Audited Financial Statements

800-899 SPECIALIZED AREAS

SLAuS 800, Special Considerations—Audits of Financial Statements Prepared in Accordance
with Special Purpose Frameworks

SLAuS 805, Special Considerations—Audits of Single Financial Statements and Specific
Elements, Accounts or Items of a Financial Statement

SLAuS 810, Engagements to Report on Summary Financial Statements

SRI LANKA AUDITING PRACTICE NOTES

SLAPN 1000, Special Considerations in Auditing Financial Instruments

REVISED STANDARDS NOT YET EFFECTIVE

SLAuS 315 (Revised), Identifying and Assessing the Risks of Material Misstatement through
Understanding the Entity and Its Environment

SLAuS 610 (Revised), Using the Work of Internal Auditors

GLOSSARY OF TERMS	
<i>Accounting records</i>	The records of initial accounting entries and supporting records, such as <u>checks</u> and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
<i>Applicable criteria (in the context of SLSAE 3410)³</i>	<u>The criteria used by the entity to quantify and report its emissions in the GHG statement.</u> <u>Applicable criteria (in the context of SLSAE 3420⁴)</u> —The criteria used by the responsible party when compiling the pro forma financial information. Criteria may be established by an authorized or recognized standard-setting organization or by law or regulation. Where established criteria do not exist, they will be developed by the responsible party.
<i>Applicable financial reporting framework</i>	The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. <u>In the context of SLSRS 4410 (Revised),⁵ reference is to the financial information, rather than to the financial statements.</u>
<i>Assertions</i>	Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur. <u>In the context of SLSAE 3410, assertions are defined as representations by the entity, explicit or otherwise, that are embodied in the GHG statement, as used by the practitioner to consider the different types of potential misstatements that may occur.</u>
<i>Assess</i>	Analyze identified risks of material misstatement to conclude on their significance. “Assess,” by convention, is used only in relation to risk. (also see <i>Evaluate</i>)
<i>Base year</i>	<u>A specific year or an average over multiple years against which an entity’s emissions are compared over time.</u>
<i>Cap and trade</i>	<u>A system that sets overall emissions limits, allocates emissions allowances to participants, and allows them to trade allowances and emission credits with each other.</u>
<i>Comparative information</i>	The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework. <u>In the context of SLSAE 3410, comparative information is defined as the amounts and disclosures included in the GHG statement in respect of one or more prior periods.</u>
<i>Compilation engagement</i>	<u>An engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework, and reports as required by this SLSRS. Throughout SLSRS 4410 (Revised), the words “compile”, “compiling” and “compiled” are used in this context.</u>
<i>Emissions</i>	<u>The GHGs that, during the relevant period, have been emitted to the atmosphere or would have been emitted to the atmosphere had they not been captured and channeled to a sink. Emissions can be categorized as:</u>

³ SLSAE 3410, Assurance Engagements on Greenhouse Gas Statements
⁴ SLSAE 3420, Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus
⁵ SLSRS 4410 (Revised), Compilation Engagements

	<ul style="list-style-type: none"> • <u>Direct emissions (also known as Scope 1 emissions), which are emissions from sources that are owned or controlled by the entity.</u> • <u>Indirect emissions, which are emissions that are a consequence of the activities of the entity, but which occur at sources that are owned or controlled by another entity. Indirect emissions can be further categorized as:</u> <ul style="list-style-type: none"> ○ <u>Scope 2 emissions, which are emissions associated with energy that is transferred to and consumed by the entity.</u> ○ <u>Scope 3 emissions, which are all other indirect emissions</u>
<i>Emissions deduction</i>	<u>Any item included in the entity’s GHG statement that is deducted from the total reported emissions, but which is not a removal; it commonly includes purchased offsets, but can also include a variety of other instruments or mechanisms such as performance credits and allowances that are recognized by a regulatory or other scheme of which the entity is a part.</u>
<i>Emissions factor</i>	<u>A mathematical factor or ratio for converting the measure of an activity (for example, liters of fuel consumed, kilometers travelled, the number of animals in husbandry, or tonnes of product produced) into an estimate of the quantity of GHGs associated with that activity.</u>
<i>Emissions trading scheme</i>	<u>A market-based approach used to control greenhouse gases by providing economic incentives for achieving reductions in the emissions of such gases.</u>
<i>Entity (in the context of SLSAE 3410)</i>	<u>The legal entity, economic entity, or the identifiable portion of a legal or economic entity (for example, a single factory or other form of facility, such as a land fill site), or combination of legal or other entities or portions of those entities (for example, a joint venture) to which the emissions in the GHG statement relate.</u>
<i>Environmental matters</i>	[Deleted]
<i>GHG statement</i>	<u>A statement setting out constituent elements and quantifying an entity’s GHG emissions for a period (sometimes known as an emissions inventory) and, where applicable, comparative information and explanatory notes including a summary of significant quantification and reporting policies. An entity’s GHG statement may also include a categorized listing of removals or emissions deductions. Where the engagement does not cover the entire GHG statement, the term “GHG statement” is to be read as that portion that is covered by the engagement. The GHG statement is the “subject matter information” of the engagement.¹⁵</u>
<i>Greenhouse gases (GHGs)</i>	<u>Carbon dioxide (CO₂) and any other gases required by the applicable criteria to be included in the GHG statement, such as: methane; nitrous oxide; sulfur hexafluoride; hydrofluorocarbons; perfluorocarbons; and chlorofluorocarbons. Gases other than carbon dioxide are often expressed in terms of carbon dioxide equivalents (CO₂-e).</u>
<i>Internal audit function</i>	<u>A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance, risk management and internal control processes.</u>
<i>Sri Lanka Accounting Standards</i>	<u>The Sri Lanka Accounting Standards adopted by the Institute of Chartered Accountants of Sri Lanka.</u>
<i>misstatement</i>	<u>In the context of SLSRS 4410 (Revised), a misstatement is defined as a difference between the amount, classification, presentation, or disclosure of a reported item in the financial information, and the amount, classification, presentation, or disclosure that is required for the</u>

	<p><u>item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.</u></p> <p><u>Where the financial information is prepared in accordance with a fair presentation framework, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the practitioner’s judgment, are necessary for the financial information to be presented fairly, in all material respects, or to give a true and fair view</u></p>
<i>Organizational boundary</i>	<u>The boundary that determines which operations to include in the entity’s GHG statement.</u>
<i>Performance materiality</i>	<p>The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures. <u>In the context of SLSAE 3410, performance materiality is defined as the amount or amounts set by the practitioner at less than materiality for the GHG statement to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the GHG statement. If applicable, performance materiality also refers to the amount or amounts set by the practitioner at less than the materiality level or levels for particular types of emissions or disclosures.</u></p>
<i>Practitioner (in the context of SLSRS 4410 (Revised))</i>	<u>A professional accountant in public practice who conducts the compilation engagement. The term includes the engagement partner or other members of the engagement team, or, as applicable, the firm. Where SLSRS 4410 (Revised) expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “practitioner” is used. “Engagement partner” and “firm” are to be read as referring to their public sector equivalents where relevant.</u>
<i>Pro forma adjustments</i>	<p><u>In relation to unadjusted financial information, these include:</u></p> <p>(a) <u>Adjustments to unadjusted financial information that illustrate the impact of a significant event or transaction (“event” or “transaction”) as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration; and</u></p> <p>(b) <u>Adjustments to unadjusted financial information that are necessary for the pro forma financial information to be compiled on a basis consistent with the applicable financial reporting framework of the reporting entity (“entity”) and its accounting policies under that framework.</u></p> <p><u>Pro forma adjustments include the relevant financial information of a business that has been, or is to be, acquired (“acquiree”), or a business that has been, or is to be, divested (“divestee”), to the extent that such information is used in compiling the pro forma financial information (“acquiree or divestee financial information”).</u></p> <p><u>Pro forma financial information—Financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. In this SLSAE, it is presumed that pro forma financial information is presented in columnar format consisting of (a) the unadjusted financial information; (b) the pro forma adjustments; and (c) the resulting pro forma column.</u></p>

<i>Professional accountant</i>	An individual who is a member of <u>an IFAC member body.</u>
<i>Professional standards</i>	<u>International Standards on Auditing (SLAuSs) and relevant ethical requirements</u>
<i>† Professional standards (in the context of SLSQC 1²¹)</i>	Engagement Standards issued by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka), as defined in the CA Sri Lanka's <i>Preface to the Sri Lanka Standards on Quality Control, Auditing, Review, Other Assurance and Related Services</i> , and relevant ethical requirements.
<i>Prospectus</i>	<u>A document issued pursuant to legal or regulatory requirements relating to the entity's securities on which it is intended that a third party should make an investment decision.</u>
<i>Published financial information</i>	<u>Financial information of the entity or of an acquiree or a divestee that is made available publicly.</u>
<i>Purchased offset</i>	<u>An emissions deduction in which the entity pays for the lowering of another entity's emissions (emissions reductions) or the increasing of another entity's removals (removal enhancements), compared to a hypothetical baseline.</u>
<i>Quantification</i>	<u>The process of determining the quantity of GHGs that relate to the entity, either directly or indirectly, as emitted (or removed) by particular sources (or sinks).</u>
<i>*† Reasonable assurance (in the context of audit engagements, and in quality control)</i>	<u>A high, but not absolute, level of assurance.</u>
<i>*† Relevant ethical requirements</i>	Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise Parts A and B of the <i>Code of Ethics for Professional Accountants</i> (CA Sri Lanka Code) together with national requirements that are more restrictive. In the context of SLSRS 4410 (Revised), relevant ethical requirements are defined as the ethical requirements the engagement team is subject to when undertaking compilation engagements. These requirements ordinarily comprise Parts A and B of the International Ethics Standards Board for Accountants' <i>Code of Ethics for Professional Accountants</i> (CA Sri Lanka Code) (excluding Section 290, <i>Independence—Audit and Review Engagements</i> , and Section 291, <i>Independence—Other Assurance Engagements</i> in Part B), together with national requirements that are more restrictive.
<i>Removal</i>	<u>The GHGs that the entity has, during the period, removed from the atmosphere, or that would have been emitted to the atmosphere had they not been captured and channeled to a sink.</u>
<i>Significant facility</i>	<u>A facility that is of individual significance due to the size of its emissions relative to the aggregate emissions included in the GHG statement or its specific nature or circumstances which give rise to particular risks of material misstatement.</u>
<i>Sink</i>	<u>A physical unit or process that removes GHGs from the atmosphere.</u>
<i>Source</i>	<u>A physical unit or process that releases GHGs into the atmosphere.</u>

²¹ SLSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<i>Sri Lanka Accounting Standards</i>	[Deleted]
<i>Type of emission</i>	<u>A grouping of emissions based on, for example, source of emission, type of gas, region, or facility.</u>
<i>Unadjusted financial information</i>	<u>Financial information of the entity to which pro forma adjustments are applied by the responsible party.</u>

SRI LANKA STANDARD ON QUALITY CONTROL 1

A66	<p>Inspection cycle policies and procedures may, for example, specify a cycle that spans three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, such as the following:</p> <ul style="list-style-type: none"> • The size of the firm. • The number and <u>geographic</u> location of offices. • The results of previous monitoring procedures. • The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them). • The nature and complexity of the firm’s practice and organization. • The risks associated with the firm’s clients and specific engagements.
-----	---

SRI LANKA FRAMEWORK FOR ASSURANCE ENGAGEMENTS

51(d)	Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, re-calculation, re-performance, analytical procedures and inquiry.
-------	--

SRI LANKA AUDITING STANDARD 200 - OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH SRI LANKA AUDITING STANDARDS

13 (d)	Auditor – <u>The</u> person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where a SLAuS expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “auditor” is used. “Engagement partner” and “firm” are to be read as referring to their public sector equivalents where relevant.
A41	<u>SLAuS 315 (Revised)</u> establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.
A43	<p>Detection risk relates to the nature, timing, and extent of the auditor’s procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:</p> <ul style="list-style-type: none"> • adequate planning;

	<ul style="list-style-type: none"> • proper assignment of personnel to the engagement team; • the application of professional <u>skepticism</u>; and • supervision and review of the audit work performed,
A69	<p>In using the objectives, the auditor is required to have regard to the interrelationships among the SLAuSs. This is because, as indicated in paragraph A53, the SLAuSs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this SLAuS requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each SLAuS. At a more detailed level, <u>SLAuS 315 (Revised)</u> and SLAuS 330 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. A SLAuS dealing with specific aspects of the audit (for example, SLAuS 540) may expand on how the objectives and requirements of such SLAuSs as <u>SLAuS 315 (Revised)</u> and SLAuS 330 are to be applied in relation to the subject of the SLAuS but does not repeat them. Thus, in achieving the objective stated in SLAuS 540, the auditor has regard to the objectives and requirements of other relevant SLAuSs.</p>
A72	<p>In some cases, a SLAuS (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in <u>SLAuS 610 (Revised)</u> is relevant.</p>

SRI LANKA AUDITING STANDARD 210 - AGREEING THE TERMS OF AUDIT ENGAGEMENTS

A23	<p>The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on SLAuS 200. Paragraphs 6(b) and 12 of this SLAuS deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:</p> <ul style="list-style-type: none"> • Elaboration of the scope of the audit, including reference to applicable legislation, regulations, SLAuSs, and ethical and other pronouncements of professional bodies to which the auditor adheres. • The form of any other communication of results of the audit engagement. • The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SLAuSs. • Arrangements regarding the planning and performance of the audit, including the composition of the <u>engagement</u> team. • The expectation that management will provide written representations (see also paragraph A13). • The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable. • The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
-----	---

	<ul style="list-style-type: none"> • The basis on which fees are computed and any billing arrangements. • A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.
--	--

SRI LANKA AUDITING STANDARD 220 - QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS

2(b)	<u>Reports</u> issued by the firm or engagement partners are appropriate in the circumstances.
A28	<p>Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:</p> <ul style="list-style-type: none"> • Significant risks identified during the engagement in accordance with <u>SLAuS 315 (Revised)</u>, and the responses to those risks in accordance with SLAuS 330, including the engagement team's assessment of, and response to, the risk of fraud in accordance with SLAuS 240. • Judgments made, particularly with respect to materiality and significant risks. • The significance and disposition of corrected and uncorrected misstatements identified during the audit. • The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies. <p>These other matters, depending on the circumstances, may also</p>
A33	In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are <u>significant</u> in the context of that audit.

SRI LANKA AUDITING STANDARD 230 - AUDIT DOCUMENTATION

A7	<p>Audit documentation provides evidence that the audit complies with the SLAuSs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment 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:</p> <ul style="list-style-type: none"> • 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 statements demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SLAuSs. • 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: <ul style="list-style-type: none"> ◦ For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide
----	---

	<p>evidence of the auditor's exercise of professional skepticism in accordance with the SLAuSs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.</p> <ul style="list-style-type: none"> ○ Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SLAuSs 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 <u>SLAuS 315 (Revised)</u>.
A8.	<p>Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:</p> <ul style="list-style-type: none"> • Matters that give rise to significant risks (as defined in SLAuS 315 (Revised)). • Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks. • Circumstances that cause the auditor significant difficulty in applying necessary audit procedures. • Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.
A19	<p>The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant only in the cases where:</p> <p>(a) The entire SLAuS is not relevant (for example, if an entity does not have an internal audit function, nothing in <u>SLAuS 610 (Revised)</u> is relevant); or</p> <p>(b) The requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).</p>
	<p>Specific Audit Documentation Requirements in Other SLAuS</p> <p>.....</p> <ul style="list-style-type: none"> • <u>SLAuS 315 (Revised)</u>, <i>Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment</i> – paragraph 32 <p>.....</p> <ul style="list-style-type: none"> • <u>SLAuS 610 (Revised)</u>, <i>Using the Work of Internal Auditors</i> – paragraph 24
<p>SRI LANKA AUDITING STANDARD 240 - THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS</p>	
1	<p>This Sri Lanka Auditing Standard (SLAuS) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how <u>SLAuS 315(Revised)</u> and SLAuS 330 are to be applied in relation to risks of material misstatement due to fraud.</p>
15	<p><u>SLAuS 315 (Revised)</u> requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)</p>

16	When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by <u>SLAuS 315 (Revised)</u> , the auditor shall perform the procedures in paragraphs 17-24 to obtain information for use in identifying the risks of material misstatement due to fraud.
19	For those entities that have an internal audit function, the auditor shall make inquiries of <u>appropriate individuals within the function</u> to determine whether <u>they have</u> knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)
25	In accordance with <u>SLAuS 315 (Revised)</u> , the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.
44	The auditor shall include the following in the audit documentation of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by <u>SLAuS 315 (Revised)</u> : (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
A18	<u>SLAuS 315 (Revised)</u> and <u>SLAuS 610 (Revised)</u> establish requirements and provide guidance <u>relevant to</u> audits of those entities that have an internal audit function. In carrying out the requirements of those SLAuSs in the context of fraud, the auditor may inquire about specific <u>activities of the function</u> including, for example: <ul style="list-style-type: none"> • The procedures performed, if any, by the internal auditors during the year to detect fraud. • Whether management has satisfactorily responded to any findings resulting from those procedures.
Appendix 1	Internal control components are deficient as a result of the following: <ul style="list-style-type: none"> • High turnover rates or employment of <u>staff in</u> accounting, information technology, <u>or the internal audit function</u> that are not effective.
SRI LANKA AUDITING STANDARD 250 - CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS	
12	As part of obtaining an understanding of the entity and its environment in accordance with <u>SLAuS 315 (Revised)</u> , the auditor shall obtain a general understanding of: (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and (b) How the entity is complying with that framework. (Ref: Para. A7)

SRI LANKA AUDITING STANDARD 260 - COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

A3	Such diversity means that it is not possible for this ISA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with <u>SLAuS 315 (Revised)</u> is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.
A14 <ul style="list-style-type: none"> Where the entity has an internal audit function, <u>how the external auditor and internal auditors can work in a constructive and complementary manner, including any planned use of the work of the internal audit function.</u>
A29 <ul style="list-style-type: none"> The person(s) in the <u>engagement</u> team and amongst those charged with governance who will communicate regarding particular matters.
A33	Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognizing management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with <u>appropriate individuals within the function</u> before communicating with those charged with governance.
A43	As noted in paragraph 4, effective two-way communication assists both the auditor and those charged with governance. Further, <u>SLAuS 315(Revised)</u> identifies participation by those charged with governance, including their interaction with <u>the internal audit function</u> , if any, and external auditors, as an element of the entity's control environment. Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.
Appendix 1	This appendix identifies paragraphs in SLSQC 1 and other SLAuSs in effect for audits of financial statements for periods beginning on or after 01 January <u>2014</u> that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in SLAuSs.
Appendix 1	Specific Requirements in SLSQC 1 and Other SLAuSs that Refer to Communications with Those Charged With Governance <ul style="list-style-type: none"> <u>SLAuS 610 (Revised), Using the Work of Internal Auditors – paragraph 18</u>

SRI LANKA AUDITING STANDARD 265 - COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT

1	This Sri Lanka Auditing Standard (SLAuS) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. This SLAuS does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of <u>SLAuS 315 (Revised)</u> and SLAuS 330 SLAuS 260 establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.
A15	<p>The level of detail at which to communicate significant deficiencies is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:</p> <ul style="list-style-type: none"> • The nature of the entity. For <u>example</u>, the communication required for a public interest entity may be different from that for a non-public interest entity. • The size and complexity of the entity. For <u>example</u>, the communication required for a complex entity may be different from that for an entity operating a simple business. • The nature of significant deficiencies that the auditor has identified. • The entity's governance composition. For <u>example</u>, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas. • Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.
A24	If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, <u>such as the internal audit function</u> or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances

SRI LANKA AUDITING STANDARD 300 - PLANNING AN AUDIT OF FINANCIAL STATEMENTS

9 (a)	The nature, timing and extent of planned risk assessment procedures, as determined under <u>SLAuS 315 (Revised)</u> .
A11	In audits of small entities, the entire audit may be conducted by a very small <u>engagement</u> team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination of, and communication between, team members are easier.

	Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 8.
Appendix 1	<p>.....</p> <ul style="list-style-type: none"> • <u>Whether the entity has an internal audit function and if so, whether, in which areas and to what extent, the work of the function can be used for purposes of the audit.</u> <p>.....</p>

SRI LANKA AUDITING STANDARD 315 - IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

SLAuS 315 (Revised) is included separately at the end of this document.

SRI LANKA AUDITING STANDARD 320 - MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

No changes

SRI LANKA AUDITING STANDARD 330 - THE AUDITOR'S RESPONSES TO ASSESSED RISKS

1	This Sri Lanka Auditing Standard (SLAuS) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with <u>SLAuS 315 (Revised)</u> in an audit of financial statements.
A1.	<p>Overall responses to address the assessed risks of material misstatement at the financial statement level may include:</p> <ul style="list-style-type: none"> • Emphasizing to the <u>engagement</u> team the need to maintain professional skepticism. • Assigning more experienced staff or those with special skills or using experts. • Providing more supervision. • Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. • 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.
A60	In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. <u>SLAuS 315 (Revised)</u> contains further guidance on revising the auditor's risk assessment.

SRI LANKA AUDITING STANDARD 402 - AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANIZATION

1	This Sri Lanka Auditing Standard (SLAuS) deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more
---	---

	service organizations. Specifically, it expands on how the user auditor applies <u>SLAuS 315 (Revised)</u> and SLAuS 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.
9	When obtaining an understanding of the user entity in accordance with <u>SLAuS 315 (Revised)</u> the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity's operations, including: (Ref: Para. A1-A2)
10	When obtaining an understanding of internal control relevant to the audit in accordance with <u>SLAuS 315 (Revised)</u> , the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization. (Ref: Para. A12-A14)
A1 <ul style="list-style-type: none"> • Reports by service organizations, <u>the internal audit function</u> or regulatory authorities on controls at the service organization.
A14	As noted in <u>SLAuS 315 (Revised)</u> in respect of some risks, the user auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. Such automated processing characteristics may be particularly present when the user entity uses service organizations. In such cases, the user entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of, and to evaluate, such controls in accordance with paragraphs 9 and 10 of this SLAuS.
A16	A service organization may engage a service auditor to report on the description and design of its controls (type 1 report) or on the description and design of its controls and their operating effectiveness (type 2 report). Type 1 or type 2 reports may be <u>issued under</u> Sri Lanka Standard on Assurance Engagements (SLSAE) 3402 or under standards established by an authorized or recognized standards setting organization (which may identify them by different names, such as Type A or Type B reports).
A22 (d)	Whether controls at the service organization are suitably designed and implemented to prevent or <u>detect and correct</u> processing errors that could result in material misstatements in the user entity's financial statements.

SRI LANKA AUDITING STANDARD 450 - EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

No Changes

SRI LANKA AUDITING STANDARD 500 - AUDIT EVIDENCE

2	This SLAuS is applicable to all the audit evidence obtained during the course of the audit. Other SLAuSs deal with specific aspects of the audit (for example, <u>SLAuS 315 (Revised)</u>), the audit evidence to be obtained in relation to a particular topic (for example, SLAuS 570), specific procedures to obtain audit evidence (for example, SLAuS 520), and the evaluation of whether sufficient appropriate audit evidence has been obtained (SLAuS 200 and SLAuS 330).
---	--

A10	As required by, and explained further in, <u>SLAuS 315 (Revised)</u> and SLAuS 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing: (a) Risk assessment procedures; and (b) Further audit procedures, which comprise:
A45	The nature of internal and external data or information the <u>management's</u> expert uses.
A51	In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as <u>as reports of the internal audit function</u> . In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.
A57	Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal <u>auditors</u> , and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. SLAuS 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.

SRI LANKA AUDITING STANDARD 501 - AUDIT EVIDENCE—SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

No changes

SRI LANKA AUDITING STANDARD 505 - EXTERNAL CONFIRMATIONS

A17	When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with <u>SLAuS 315 (Revised)</u> . For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with SLAuS 240.
A19	The nature and extent of alternative audit procedures are affected by the account and assertion in question. A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with <u>SLAuS 315 (Revised)</u> . For example, fewer responses to confirmation requests than anticipated, or a greater number of responses than anticipated, may indicate a previously unidentified fraud risk factor that requires evaluation in accordance with SLAuS 240.

SRI LANKA AUDITING STANDARD 510 - INITIAL AUDIT ENGAGEMENTS—OPENING BALANCES

9	If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with <u>SLAuS 315 (Revised)</u> .
---	--

A2	<p>If the statutorily appointed auditor outsources an audit of a public sector entity to a private sector audit firm, and the statutorily appointed auditor appoints an audit firm other than the firm that audited the financial statements of the public sector entity in the prior period, this is not usually regarded as a change in auditors for the statutorily appointed auditor. Depending on the nature of the outsourcing arrangement, however, the audit engagement may be considered an initial audit engagement from the perspective of the private sector auditor in fulfilling <u>the auditor's responsibilities</u>, and therefore this SLAuS applies.</p>
<p>Appendix (Ref: Para. A8)</p>	<p>Illustrations of Auditors' Reports with Modified Opinions Illustration 1 Report on the Financial Statements</p> <p>We have audited the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position</u> as at December 31, 20X1, and the <u>statement of comprehensive income</u>, statement of changes in equity and <u>statement of cash flows</u> for the year then ended, and a summary of significant accounting policies and other explanatory information.</p>
	<p><i>Basis for Qualified Opinion</i></p> <p>We were appointed as auditors of the company on June 30, 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at December 31, 20X0. Since opening inventories enter into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the statement <u>of comprehensive income</u> and the net cash flows from operating activities reported in the statement <u>of cash flows</u>.</p>
	<p>Illustration 2 Report on the Financial Statements</p> <p>We have audited the accompanying financial statements of ABC Company, <u>which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u></p>
	<p><i>Basis for Qualified Opinion on the Financial Performance and Cash Flows</i></p> <p>We were appointed as auditors of the company on June 30, 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at December 31, 20X0. Since opening inventories enter into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the <u>statement of comprehensive income and the net cash flows from operating activities reported in the statement of cash flows.</u></p>
	<p><i>Qualified Opinion on the Financial Performance and Cash Flows</i></p> <p>In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the <u>Statement of Comprehensive Income and Statement of Cash Flows present fairly, in all material respects (or give a true and fair view of), the financial performance</u></p>

	<u>and cash flows of ABC Company for the year ended December 31, 20X1 in accordance with International Financial Reporting Standards.</u>
	<p><i>Opinion on the Financial Position</i></p> <p>In our opinion, the <u>statement of financial position</u> presents fairly, in all material respects (or <i>gives a true and fair view of</i>) the financial position of ABC Company as at December 31, 20X1 in accordance with Sri Lanka Accounting Standards.</p>

SRI LANKA AUDITING STANDARD 520 - ANALYTICAL PROCEDURES

1	This Sri Lanka Auditing Standard (SLAuS) deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"). It also deals with the auditor's responsibility to perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. <u>SLAuS 315 (Revised)</u> deals with the use of analytical procedures as risk assessment procedures. SLAuS 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures.
A18	The results of such analytical procedures may identify a previously unrecognized risk of material misstatement. In such circumstances, <u>SLAuS 315 (Revised)</u> requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.

SRI LANKA AUDITING STANDARD 530 - AUDIT SAMPLING

Appendix 2

Examples

	FACTOR	EFFECT ON SAMPLE SIZE	
	5	Negotiable effect	For large populations, the actual size of the population has little, if any, effect on sample size. <u>Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence.</u>

SRI LANKA AUDITING STANDARD 540 - AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES

1	This Sri Lanka Auditing Standard (SLAuS) deals with the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how <u>SLAuS 315 (Revised)</u> and SLAuS 330 and other relevant SLAuSs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.
8	When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by <u>SLAuS 315 (Revised)</u> , the auditor shall obtain an understanding of the following in order to provide a

	basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para. A12)
10	In identifying and assessing the risks of material misstatement, as required by <u>SLAuS 315 (Revised)</u> , the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. (Ref: Para. A45-A46)
A20	During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. <u>SLAuS 315 (Revised)</u> 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 processes. ¹¹
A87	There are alternative sources of relevant data available to the auditor which can be used in <u>developing</u> a point estimate or a range.
A90	The ability of the auditor to <u>develop</u> a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range 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).
A92	When the auditor <u>develops</u> a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

SRI LANKA AUDITING STANDARD 550 - RELATED PARTIES

1	This Sri Lanka Auditing Standard (SLAuS) deals with the auditor's responsibilities relating to related party relationships and transactions in an audit of financial statements. Specifically, it expands on how <u>SLAuS 315 (Revised)</u> , SLAuS 330, and SLAuS 240 are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.
11	As part of the risk assessment procedures and related activities that <u>SLAuS 315 (Revised)</u> and SLAuS 240 require the auditor to perform during the audit the auditor shall perform the audit

¹¹ SLAuS 315 (Revised), paragraph 16.

	procedures and related activities set out in paragraphs 12-17 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. (Ref: Para. A8)
12	The engagement team discussion that <u>SLAuS 315 (Revised)</u> and SLAuS 240 require shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. (Ref: Para. A9-A10)
18	In meeting the <u>SLAuS 315 (Revised)</u> requirement to identify and assess the risks of material misstatement, the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.
A12	<p>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 inquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this SLAuS. In such a case, however, the auditor's inquiries 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 <u>SLAuS 315 (Revised)</u> to obtain information regarding:</p> <ul style="list-style-type: none"> • 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. <p>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 inquiries 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.</p>
A15	<p>Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. These may include, to the extent that they do not form part of management:</p> <ul style="list-style-type: none"> • Those charged with governance; • Personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business, and those who supervise or monitor such personnel; • <u>The internal audit function;</u> • In-house legal counsel; and • The chief ethics officer or equivalent person.
A17	<p>In meeting the <u>SLAuS 315 (Revised)</u> requirement to obtain an understanding of the control environment, the auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as:</p> <ul style="list-style-type: none"> • Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.

	<ul style="list-style-type: none"> • Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions. • The assignment of responsibilities within the entity for identifying, recording, summarizing, and disclosing related party transactions. • Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity's normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors). • Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management. • <u>Periodic reviews by the internal audit function, where applicable.</u> • Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel. • The existence of whistle-blowing policies and procedures, where applicable.
A22	<p>During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:</p> <ul style="list-style-type: none"> • Third-party confirmations obtained by the auditor (in addition to bank and legal confirmations). • Entity income tax returns. • Information supplied by the entity to regulatory authorities. • Shareholder registers to identify the entity's principal shareholders. • Statements of conflicts of interest from management and those charged with governance. • Records of the entity's investments and those of its pension plans. • Contracts and agreements with key management or those charged with governance. • Significant contracts and agreements not in the entity's ordinary course of business. • Specific invoices and correspondence from the entity's professional advisors. • Life insurance policies acquired by the entity. • Significant contracts re-negotiated by the entity during the period. • <u>Reports of the internal audit function.</u> • Documents associated with the entity's filings with a securities regulator (for example, prospectuses). <p>Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions <u>(Ref: Para. 15).</u></p>
A40	<p>Authorization and approval by management, those charged with governance, or, where applicable, the shareholders of significant related party transactions outside the entity's normal course of business may provide audit evidence that these have been duly considered at the</p>

	appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorization and approval, in the absence of rational explanations based on discussion with management or those charged with governance, may indicate risks of material misstatement due to <u>fraud or error</u> . In these circumstances, the auditor may need to be alert for other transactions of a similar nature. Authorization and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorization and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of a related party.
--	--

SRI LANKA AUDITING STANDARD 560 - SUBSEQUENT EVENTS

No Changes

SRI LANKA AUDITING STANDARD 570 - GOING CONCERN

10	When performing risk assessment procedures as required by <u>SLAuS 315 (Revised)</u> , the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and: (Ref: Para. A2-A5)
19 (b)	Draw attention to the note in the financial statements that discloses the matters set out in paragraph 18. <u>(Ref: Para. A21-A22)</u>

SRI LANKA AUDITING STANDARD 580 - WRITTEN REPRESENTATIONS

A3	Due to its responsibility for the preparation of the financial statements, and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in <u>preparing</u> the financial statements and the assertions therein on which to base the written representations.
Appendix 1	List of SLAuSs Containing Requirements for Written Representations This appendix identifies paragraphs in other SLAuSs in effect for audits of financial statements for periods beginning on or after <u>01 January 2014</u> that require subject-matter specific written representations. The list is not a substitute for considering the requirements and related application and other explanatory material in SLAuSs.
Appendix 2	Illustrative Representation Letter The following illustrative letter includes written representations that are required by this and other SLAuSs in effect for audits of financial statements for periods beginning on or after <u>01 January 2014</u> . It is assumed in this illustration that the applicable financial reporting framework is Sri Lanka Accounting Standards; the requirement of SLAuS 570 to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

SRI LANKA AUDITING STANDARD 600 - SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)

A2	The structure of a group affects how components are identified. For example, the group financial reporting system may be based on an organizational structure that provides for
----	---

	financial information to be prepared by a parent and one or more subsidiaries, joint ventures, or investees accounted for by the equity or cost methods of accounting; by a head office and one or more divisions or branches; or by a combination of both. Some groups, however, may organize their financial reporting system by function, process, product or service (or by groups of products or services), or <u>geographic</u> locations. In these cases, the entity or business activity for which group or component management prepares financial information that is included in the group financial statements may be a function, process, product or service (or group of products or services), or <u>geographic</u> location.
A23	<u>SLAuS 315 (Revised)</u> contains guidance on matters the auditor may consider when obtaining an understanding of the industry, regulatory, and other external factors that affect the entity, including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance. Appendix 2 of this SLAuS contains guidance on matters specific to a group, including the consolidation process.
A27 <ul style="list-style-type: none"> • <u>Responses of those charged with governance of the group, group management, appropriate individuals within the internal audit function</u> (and if considered appropriate, component management, the component auditors, and others) to the group engagement team's inquiry whether they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group.
A51 <ul style="list-style-type: none"> • <u>Whether the internal audit function has performed work at the component and any effect of that work on the group audit.</u>
Appendix 1	Example of a Qualified Opinion Where the Group Engagement Team Is Not Able to Obtain Sufficient Appropriate Audit Evidence on Which to Base the Group Audit Opinion In this example, the group engagement team is unable to obtain sufficient appropriate audit evidence relating to a significant component accounted for by the equity method (recognized at Rs 15 million in the <u>statement of financial position</u> , which reflects total assets of Rs 60 million) because the group engagement team did not have access to the accounting records, management, or auditor of the component.
Appendix 1	Report on the Consolidated Financial Statements We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated <u>statement of financial position as at December 31, 20X1</u> , and the consolidated <u>statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended</u> , and a summary of <u>significant accounting policies and other explanatory information</u> .
Appendix 1	<i>Basis for Qualified Opinion</i> ABC Company's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs 15 million on the consolidated <u>statement of financial position</u> as at December 31, 20X1, and ABC's share of XYZ's net income of Rs 1 million is included in the consolidated <u>statement of comprehensive income</u> for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of

	XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.
Appendix 2 Para 1 • <u>Monitoring of controls, including activities of the internal audit function and self-assessment programs.</u>
Appendix 2 Para 2	<u>The internal audit function may be regarded as part of group-wide controls, for example, when the function is centralized. SLAuS 610 (Revised) deals with the group engagement team's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately supports the objectivity of internal auditors, the level of competence of the internal audit function, and whether the function applies a systematic and disciplined approach where the group audit team expects to use the function's work.</u>
Appendix 5 • <u>The findings of the internal audit function, based on work performed on controls at or relevant to components.</u>

SRI LANKA AUDITING STANDARD 610 - USING THE WORK OF INTERNAL AUDITORS

SLAuS 610 (Revised) is included separately at the end of this document.

SRI LANKA AUDITING STANDARD 620 - USING THE WORK OF AN AUDITOR'S EXPERT

No Changes

SRI LANKA AUDITING STANDARD 700 - FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

A23	In some jurisdictions, law or regulation prescribing management's responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system. As books, records and systems are an integral part of internal control (as defined in SLAuS 315 (Revised), the descriptions in SLAuS 210 and in paragraph 26 do not make specific reference to them.
Appendix Illustration 1	Report on the Financial Statements We have audited the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u>
Illustration 3:	We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated <u>statement of financial position</u> as at December 31, 20X1, and the consolidated <u>statement of comprehensive income</u> , statement of changes in equity and <u>statement of cash flows</u> for the year then ended, and a summary of significant accounting policies and other explanatory information.

SRI LANKA AUDITING STANDARD 705 - MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

Heading A4.	<p><i>Application of the Selected Accounting Policies</i></p> <p>In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise when:</p>
Appendix - Illustration 1	<p>Report on the Financial Statements</p> <p>We have audited the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u></p> <p>Basis for Qualified Opinion</p> <p>The company's inventories are carried in the <u>statement of financial position</u> at xxx.</p>
Illustration 2:	<p>Report on the Financial Statements</p> <p>We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated <u>statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u></p>
Appendix - Illustration 3	<p>Report on the Financial Statements</p> <p>We have audited the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u></p> <p>Basis for Qualified Opinion</p> <p>ABC Company's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the <u>statement of financial position</u> as at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.</p>
Appendix - Illustration 4	<p>Report on the Financial Statements</p> <p>We were engaged to audit the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year</u></p>

	<p><u>then ended, and a summary of significant accounting policies and other explanatory information.</u></p>
<p>Appendix - <u>Illustration 5</u></p>	<p>Report on the Financial Statements</p> <p>We were engaged to audit the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position</u> as at December 31, 20X1, and the <u>statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u></p> <p>Basis for Disclaimer of Opinion</p> <p>We were not appointed as auditors of the company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1 which are stated in the <u>statement of financial position</u> at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the <u>statement of financial position</u> at a total amount of xxx as at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the <u>statement of comprehensive income, statement of changes in equity and statement of cash flows.</u></p>
<p>SRI LANKA AUDITING STANDARD 706 - EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT</p>	
<p>Appendix 3</p>	<p>Report on the Financial Statements</p> <p>We have audited the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position</u> as at December 31, 20X1, and the <u>statement of comprehensive income, statement of changes in equity and statement of cash flows</u> for the year then ended, and a summary of significant accounting policies and other explanatory information.</p> <p>Basis for Qualified Opinion</p> <p>The company's short-term marketable securities are carried in the <u>statement of financial position</u> at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from International Financial Reporting Standards. The company's records indicate that had management marked the marketable securities to market, the company would have recognized an unrealized loss of xxx in the <u>statement of comprehensive income</u> for the year. The carrying amount of the securities in the <u>statement of financial position</u> would have been reduced by the same amount at December 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.</p>

SRI LANKA AUDITING STANDARD 710 - COMPARATIVE INFORMATION— CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS

Appendix – Illustration 1 Corresponding Figures (Ref: Para. A5)	Report on the Financial Statements We have audited the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u>
Appendix - Illustration 2 Corresponding Figures (Ref: Para. A5)	Report on the Financial Statements We have audited the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u>
Appendix - Illustration 3 - Corresponding Figures (Ref: Para. A7)	Report on the Financial Statements We have audited the accompanying financial statements of ABC Company, which comprise the <u>statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.</u>
Illustration 4 - Comparative Financial Statements (Ref: Para. A9)	Report on the Financial Statements We have audited the accompanying financial statements of ABC Company, which comprise the <u>statements of financial position as at December 31, 20X1 and 20X0, and the statements of comprehensive income, statements of changes in equity and statements of cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.</u>
	No changes

SRI LANKA AUDITING STANDARD 800 - SPECIAL CONSIDERATIONS—AUDITS OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH SPECIAL PURPOSE FRAMEWORKS

10	<u>SLAuS 315 (Revised)</u> requires the auditor to obtain an understanding of the entity's selection and application of accounting policies. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements. An interpretation is significant when adoption of another reasonable interpretation would have produced a material difference in the information presented in the financial statements.
----	--

1. SRI LANKA AUDITING STANDARD 805 - SPECIAL CONSIDERATIONS— AUDITS OF SINGLE FINANCIAL STATEMENTS AND SPECIFIC ELEMENTS, ACCOUNTS OR ITEMS OF A FINANCIAL STATEMENT

4	This SLAuS is effective for audits of single financial statements or of specific elements, accounts or items for periods <u>beginning on or after 01 January 2014</u> . In the case of audits of single financial statements or of specific elements, accounts or items of a financial statement prepared as at a specific date, this SLAuS is effective for audits of such information prepared as at a date on or after 01 January 2014.
---	--

SRI LANKA AUDITING STANDARD 810 - ENGAGEMENTS TO REPORT ON SUMMARY FINANCIAL STATEMENTS

Appendix - Illustration 3

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

[Appropriate Addressee]

The accompanying summary financial statements, which comprise the summary statement of financial position as at December 31, 20X1, the summary statement of comprehensive income, summary statement of changes in equity and summary statement of cash flows for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended December 31, 20X1.

Appendix - Illustration 3

Opinion

The misstatement of the audited financial statements is described in our qualified audit opinion in our report dated February 15, 20X2. Our qualified audit opinion is based on the fact that the company's inventories are carried in the statement of financial position in those financial statements at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from Sri Lanka Accounting Standards. The company's records indicate that had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively. Our qualified audit opinion states that, except for the effects of the described matter, those financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

SRI LANKA AUDITING STANDARD 315 (REVISED)

AUDITING
**IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT
THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

(Effective for audits of financial statements for periods beginning on or after 01 January 2015)

CONTENTS

	Paragraph
Introduction	
Scope of this SLAuS	1
Effective Date	2
Objective	3
Definitions	4
Requirements	
Risk Assessment Procedures and Related Activities	5–10
The Required Understanding of the Entity and Its Environment, Including the Entity’s Internal Control	11–24
Identifying and Assessing the Risks of Material Misstatement	25–31
Documentation	32
Application and Other Explanatory Material	
Risk Assessment Procedures and Related Activities	A1–A23
The Required Understanding of the Entity and Its Environment, Including the Entity’s Internal Control	A24–A117
Identifying and Assessing the Risks of Material Misstatement	A118–A143
Documentation	A144–A147
Appendix 1: Internal Control Components	
Appendix 2: Conditions and Events That May Indicate Risks of Material Misstatement	

Sri Lanka Auditing Standard (SLAuS) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, should be read in conjunction with SLAuS 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Sri Lanka Auditing Standards*. AUDITING

Introduction

Scope of this SLAuS

1. This Sri Lanka Auditing Standard (SLAuS) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

Effective Date

2. This SLAuS is effective for audits of financial statements for periods beginning on or after 01 January, 2015.

Objective

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

Definitions

4. For purposes of the SLAuSs, the following terms have the meanings attributed below:
 - (a) Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
 - (b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
 - (c) Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
 - (d) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
 - (e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a 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. A1–A5)
6. The risk assessment procedures shall include the following:
 - (a) Inquiries 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 judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6–A13)

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

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

7. The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.
8. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.
9. 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 determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A19–A20)
10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A21–A23)

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

The Entity and Its Environment

11. 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. A24–A29)
- (b) The nature of the entity, including:
 - (i) its operations;
 - (ii) its ownership and governance structures;
 - (iii) the types of investments that the entity is making and plans to make, including investments in 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 statements. (Ref: Para. A30–A34)
- (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. A35)
- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A36–A42)
- (e) The measurement and review of the entity's financial performance. (Ref: Para. A43–A48)

The Entity's Internal Control

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A49–A72)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A73–A75)

Components of Internal Control

Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
 - (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A76–A86)

The entity's risk assessment process

15. The auditor shall obtain an understanding of whether the entity has a process for:
- (a) Identifying business risks relevant to financial reporting objectives;
 - (b) Estimating the significance of the risks;
 - (c) Assessing the likelihood of their occurrence; and
 - (d) Deciding about actions to address those risks. (Ref: Para. A87)
16. If the entity has established such a process (referred to hereafter as the “entity's risk assessment process”), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.
17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A88)

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

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

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

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A94–A95)

- (a) Communications between management and those charged with governance; and
- (b) External communications, such as those with regulatory authorities.

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A96–A102)

21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A103–A105)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A106–A108)

23. If the entity has an internal audit function,¹ the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A109–A116)

24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A117)

¹ SLAuS 610 (Revised), *Using the Work of Internal Auditors*, paragraph 12, defines the term "internal audit function" for purposes of the SLAuSs.

Identifying and Assessing the Risks of Material Misstatement

25. The auditor shall identify and assess the risks of material misstatement at:

- (a) the financial statement level; and (Ref: Para. A118–A121)
- (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A122–A126) to provide a basis for designing and performing further audit procedures.

26. For this purpose, the auditor shall:

- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A127–A128)
- (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A129–A131)
- (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that Require Special Audit Consideration

27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (a) Whether the risk is a risk of fraud;
- (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
- (c) The complexity of transactions;
- (d) Whether the risk involves significant transactions with related parties;
- (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A132–A136)

29. 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. (Ref: Para. A137–A139)

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

30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A140–A142)

Revision of Risk Assessment

31. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances 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 assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A143)

Documentation

32. The auditor shall include in the audit documentation:²

- (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;
- (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14–24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and
- (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27–30. (Ref: Para. A144–A147)

Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities (Ref: Para. 5)

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

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with SLAuS 320;³
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;

² SLAuS 230, *Audit Documentation*, paragraphs 8–11, and A6

³ SLAuS 320, *Materiality in Planning and Performing an Audit*

- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
 - Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management’s oral and written representations.
- A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.
- A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor’s primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this SLAuS. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.
- A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SLAuS. However, the significance of fraud is such that further requirements and guidance are included in SLAuS 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.⁴
- A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11–24), 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 such procedures include:
- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
 - Making inquiries of the entity’s external legal counsel or of valuation experts that the entity has used.

Inquiries of Management, the Internal Audit Function and Others within the Entity (Ref: Para. 6(a))

- A6. Much of the information obtained by the auditor’s inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.
- A7. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:
- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. SLAuS 260⁵ identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
 - Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.

⁴ SLAuS 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 12–24

⁵ SLAuS 260, *Communication with Those Charged with Governance*, paragraph 4(b)

- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- Inquiries 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.
- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.

A8. As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

Inquiries of the Internal Audit Function

A9. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries 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.⁶ Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

A10. If, based on responses to the auditor's inquiries, 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.

A11. In addition, in accordance with SLAuS 240,⁷ 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.

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

⁶ The relevant requirements are contained in SLAuS 610 (Revised).

⁷ SLAuS 240, paragraph 19

Considerations specific to public sector entities (Ref: Para 6(a))

A13. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.

Analytical Procedures (Ref: Para. 6(b))

A14. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

A15. 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.

A16. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller Entities

A17. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Observation and Inspection (Ref: Para. 6(c))

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

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

Information Obtained in Prior Periods (Ref: Para. 9)

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

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).

- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

A20. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion among the Engagement Team (Ref: Para. 10)

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

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

SLAuS 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.⁸

A22. 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, taking 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 Smaller Entities

A23. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

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

The Entity and Its Environment

Industry, Regulatory and Other External Factors (Ref: Para. 11(a))

Industry Factors

A24. 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.

A25. 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.⁹

Regulatory Factors

A26. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

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

A27. SLAuS 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.¹⁰

Considerations specific to public sector entities

A28. For the audits of public sector entities, law, regulation or other authority may affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other External Factors

A29. 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.

Nature of the Entity (Ref: Para. 11(b))

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

- Whether the entity has a complex structure, for example, with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.
- The ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately. SLAuS 550¹¹ establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

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

- 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, pension 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.
- 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.
- 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.
- Financial reporting such as:
 - Accounting principles and industry-specific practices, including industry-specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
 - Revenue recognition practices.
 - Accounting for fair values.
 - Foreign currency assets, liabilities and transactions.
 - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A32. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

Nature of Special-Purpose Entities

A33. 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 securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which 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 SLAuS 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.¹²

A34. 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.

The Entity's Selection and Application of Accounting Policies (Ref: Para. 11(c))

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

- The methods the entity uses to account for significant and unusual transactions.

- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes 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 such requirements.

Objectives and Strategies and Related Business Risks (Ref: Para. 11(d))

A36. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

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

A38. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

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

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, 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 systems and processes are incompatible).

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A40. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.

A41. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A87–A88.

Considerations Specific to Public Sector Entities

A42. For the audits of public sector entities, “management objectives” may be influenced by concerns regarding public accountability and may include objectives which have their source in law, regulation or other authority.

Measurement and Review of the Entity's Financial Performance (Ref: Para. 11(e))

A43. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. See SLAuS 240 for requirements and guidance in relation to the risks of fraud.

A44. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A106-A117), 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).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

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

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

- Key performance indicators (financial and 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.

A46. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A47. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations Specific to Smaller Entities

A48. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Entity's Internal Control (Ref: Para. 12)

A49. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.

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

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

General Nature and Characteristics of Internal Control

Purpose of Internal Control

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

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

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Considerations specific to smaller entities

A52. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of Internal Control

A53. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, 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 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.

A54. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into 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 a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

A55. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Considerations specific to smaller entities

A56. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

A57. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Division of Internal Control into Components

A58. The division of internal control into the following five components, for purposes of the SLAuSs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

- (a) The control environment;
- (b) The entity's risk assessment process;
- (c) The information system, including the related business processes, relevant to financial reporting, and communication;
- (d) Control activities; and
- (e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or

frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this SLAuS, provided all the components described in this SLAuS are addressed.

A59. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A76–A117 below. Appendix 1 provides further explanation of these components of internal control.

Characteristics of Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment

A60. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A61. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

A62. Generally, IT benefits an entity's internal control by enabling an entity to:

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

A63. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or 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.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

A64. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

A65. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

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

A66. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

A67. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A68. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.

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

A69. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

A70. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.

A71. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

Considerations Specific to Public Sector Entities

A72. Public sector auditors often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice. Public sector auditors can also have responsibilities to report on compliance with law, regulation or other authority. As a result, their review of internal control may be broader and more detailed.

Nature and Extent of the Understanding of Relevant Controls (Ref: Para. 13)

A73. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.

A74. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.

- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

A75. Obtaining an understanding of an entity's controls 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, because of the inherent consistency of IT processing (see paragraph A62), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in SLAuS 330.¹³

Components of Internal Control—Control Environment (Ref: Para. 14)

A76. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A77. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- Participation by those charged with governance* – Attributes of those charged with governance such as:
 - Their independence from management.
 - Their experience and stature.
 - The extent of their involvement and the information they receive, and the scrutiny of activities.
 - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- Management's philosophy and operating style* – Characteristics such as management's:
 - Approach to taking and managing business risks.
 - Attitudes and actions toward financial reporting.
 - Attitudes toward information processing and accounting functions and personnel.
- Organizational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

- (f) *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
- (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Audit Evidence for Elements of the Control Environment

- A78. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.
- A79. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

Effect of the Control Environment on the Assessment of the Risk of Material Misstatement

- A80. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management 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 statements are prepared in accordance with the applicable financial reporting framework.
- A81. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.
- A82. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or

unauthorized transactions to be processed. As explained in SLAuS 330, the control environment also influences the nature, timing and extent of the auditor's further procedures.¹⁴

- A83. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Considerations Specific to Smaller Entities

- A84. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small 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. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small entity; it may, however, increase other risks, for example, the risk of override of controls.

- A85. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

- A86. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 15)

- A87. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Considerations Specific to Smaller Entities (Ref: Para. 17)

- A88. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

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

The Information System, Including Related Business Processes, Relevant to Financial Reporting (Ref: Para. 18)

- A89. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

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

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

Journal entries

- A90. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.
- A91. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes

- A92. An entity's business processes are the activities designed to:
- Develop, purchase, produce, sell and distribute an entity's products and services;
 - Ensure compliance with laws and regulations; and
 - Record information, including accounting and financial reporting information.

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

Considerations specific to smaller entities

- A93. Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

Communication (Ref: Para. 19)

A94. 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 internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A95. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control-Control Activities Relevant to the Audit (Ref: Para. 20)

A96. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

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

A97. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- Those that are considered to be relevant in the judgment of the auditor.

A98. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A99. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A100. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations Specific to Smaller Entities

A101. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A102. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks Arising from IT (Ref: Para. 21)

A103. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT controls and application controls.

A104. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

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

They are generally implemented to deal with the risks referred to in paragraph A63 above.

A105. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control-Monitoring of Controls (Ref: Para. 22)

A106. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A107. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations Specific to Smaller Entities

A108. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

The Entity's Internal Audit Function (Ref: Para. 23)

A109. If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(a) of this SLAuS, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

A110. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.

A111. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

A112. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) of this SLAuS 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.

A113. 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.

A114. 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, SLAuS 610 (Revised) applies.

A115. As is further discussed in SLAuS 610 (Revised), 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.

A116. 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. SLAuS 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring 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.

Sources of Information (Ref: Para. 24)

A117. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- the 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,

is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 25(a))

A118. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A119. Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A120. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

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

A121. SLAuS 705¹⁵ 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.

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 25(b))

A122. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

A123. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

A124. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

- (a) Assertions about classes of transactions and events for the period under audit:
 - (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - (iv) Cutoff—transactions and events have been recorded in the correct accounting period.
 - (v) Classification—transactions and events have been recorded in the proper accounts.
- (b) Assertions about account balances at the period end:
 - (i) Existence—assets, liabilities, and equity interests exist.
 - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
 - (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

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

A125. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

Considerations specific to public sector entities

A126. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A124, 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.

Process of Identifying Risks of Material Misstatement (Ref: Para. 26(a))

A127. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed.

A128. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Relating Controls to Assertions (Ref: Para. 26(c))

A129. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A130. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A131. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly,

it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks

Identifying Significant Risks (Ref: Para. 28)

A132. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A133. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

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

A134. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

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

A135. SLAuS 330 describes the consequences for further audit procedures of identifying a risk as significant.¹⁶

Significant risks relating to the risks of material misstatement due to fraud

A136. SLAuS 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.¹⁷

Understanding Controls Related to Significant Risks (Ref: Para. 29)

A137. Although risks relating to significant non-routine or judgmental 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 judgmental matters includes whether and how management responds to the risks. Such responses might include:

- Control activities such as a review of assumptions by senior management or experts.
- Documented processes for estimations.
- Approval by those charged with governance.

¹⁶ SLAuS 330, paragraphs 15 and 21

¹⁷ SLAuS 240, paragraphs 25–27

A138. 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 statements.

A139. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.¹⁸

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence
(Ref: Para. 30)

A140. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A141. 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 integrated system. In such cases:

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

A142. The consequences for further audit procedures of identifying such risks are described in SLAuS 330.¹⁹

Revision of Risk Assessment (Ref: Para. 31)

A143. 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. See SLAuS 330 for further guidance.

Documentation (Ref: Para. 32)

A144. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be

¹⁸ SLAuS 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A7

¹⁹ SLAuS 330, paragraph 8

incorporated in the auditor's documentation of the overall strategy and audit plan.²⁰ 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.²¹ The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A145. For entities that have uncomplicated businesses and processes relevant to financial reporting, the 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 include those on which the auditor based the assessment of the risks of material misstatement.

A146. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of SLAuS 230 are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A147. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

Appendix I

(Ref: Para. 4(c), 14-24, A76 – A117)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14–24 and A76–A117, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:
 - (a) *Communication and enforcement of integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
 - (b) *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
 - (c) *Participation by those charged with governance.* An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

²⁰ SLAuS 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

²¹ SLAuS 330, paragraph 28

- (d) *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
- (e) *Organizational structure.* Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.
- (f) *Assignment of authority and responsibility.* The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
- (g) *Human resource policies and practices.* Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

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 statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
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 data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
 - *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
 - *New personnel.* New personnel may have a different focus on or understanding of internal control.
 - *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.

- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

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

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).
6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:
 - Identify and record all valid transactions.
 - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
 - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
 - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
 - Present properly the transactions and related disclosures in the financial statements.
7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:
 - *Performance reviews.* These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective

actions; comparing internal data with external sources of information; and review of functional or activity performance.

- *Information processing.* The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
- *Physical controls.* Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorization for access to computer programs and data files.
 - 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, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.

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

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

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring 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.

12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.
13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A40, A128)

Conditions and Events That May Indicate Risks of Material Misstatement

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

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

- Inconsistencies between the entity's IT strategy and its business strategies.
 - Changes in the IT environment.
 - Installation of significant new IT systems related to financial reporting.
 - Inquiries into the entity's operations or financial results by regulatory or government bodies.
 - Past misstatements, history of errors or a significant amount of adjustments at period end.
 - Significant amount of 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.
 - Application of new accounting pronouncements.
 - Accounting measurements that involve complex processes.
 - Events or transactions that involve significant measurement uncertainty, including accounting estimates.
 - Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.
-

SRI LANKA AUDITING STANDARD 610 (REVISED)

USING THE WORK OF INTERNAL AUDITORS

(Effective for audits of financial statements for periods beginning on or after 01 January, 2015)

CONTENTS

	Paragraph
Introduction	
Scope of this SLAuS	1–4
Relationship between SLAuS 315 (Revised) and SLAuS 610 (Revised)	5–8
The External Auditor’s Responsibility for the Audit.....	9
Effective Date	10
Objectives	11
Definition	12
Requirements	
Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used	13–18
Using the Work of the Internal Audit Function	19–23
Documentation	24
Application and Other Explanatory Material	
Definition of Internal Audit Function	A1–A4
Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used	A5–A23
Using the Work of the Internal Audit Function	A24–A30

Sri Lanka Auditing Standard (SLAuS) 610 (Revised), Using the Work of Internal Auditors, should be read in conjunction with SLAuS 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Sri Lanka Auditing Standards.

Introduction

Scope of this SLAuS

1. This Sri Lanka Auditing Standard (SLAuS) deals with the external auditor’s responsibilities if using the work of the internal audit function in obtaining audit evidence.
2. This SLAuS does not apply if the entity does not have an internal audit function. (Ref: Para. A2)
3. If the entity has an internal audit function, the requirements in this SLAuS do not apply if:

- (a) The responsibilities and activities of the function are not relevant to the audit; or
- (b) Based on the auditor's preliminary understanding of the function obtained as a result of procedures performed under SLAuS 315 (Revised),²² the external auditor does not expect to use the work of the function in obtaining audit evidence.

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

- 4. In some jurisdictions, the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function. The SLAuSs do not override laws or regulations that govern an audit of financial statements.²³ Such prohibitions or restrictions will therefore not prevent the external auditor from complying with the SLAuSs.

Relationship between SLAuS 315 (Revised) and SLAuS 610 (Revised)

- 5. Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.
- 6. SLAuS 315 (Revised) addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment and identification and assessment of risks of material misstatement. SLAuS 315 (Revised)²⁴ also explains how effective communication between the internal and external auditors also creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.
- 7. Depending on whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competency of the internal audit function, and whether the function applies a systematic and disciplined approach, the external auditor may also be able to use the work of the internal audit function in a constructive and complementary manner. This SLAuS addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function obtained as a result of procedures performed under SLAuS 315 (Revised), the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained.²⁵ Such use of that work modifies the nature or timing, or reduces the extent, of audit procedures to be performed directly by the external auditor.
- 8. There may be individuals in an entity that perform procedures similar to those performed by an internal audit function. However, unless performed by an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered internal controls and obtaining evidence regarding the effectiveness of such controls would be part of the auditor's responses to assessed risks in accordance with SLAuS 330.²⁶

²² SLAuS 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

²³ SLAuS 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A55

²⁴ SLAuS 315 (Revised), paragraph A116

²⁵ See paragraphs 13–23.

²⁶ SLAuS 330, *The Auditor's Responses to Assessed Risk*

The External Auditor's Responsibility for the Audit

9. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function on the engagement. Although the function may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SLAuS 200.²⁷ This SLAuS, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of the internal audit function to prevent over or undue use of such work.

Effective Date

10. This SLAuS is effective for audits of financial statements for periods beginning on or after 01 January, 2015.

Objectives

11. The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor are:
- (a) To determine whether the work of the internal audit function can be used, and if so, in which areas and to what extent;
and having made that determination:
 - (b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit.

Definition

12. For purposes of the SLAuSs, the following term has the meaning attributed below:

Internal audit function – A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes. (Ref: Para. A1–A4)

Requirements

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

Evaluating the Internal Audit Function

13. The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:
- (a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (Ref: Para. A5–A9)

²⁷ SLAuS 200, paragraph 14

- (b) The level of competence of the internal audit function; and (Ref: Para. A5–A9)
 - (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control. (Ref: Para. A10–A11)
14. The external auditor shall not use the work of the internal audit function if the external auditor determines that:
- (a) The function’s organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
 - (b) The function lacks sufficient competence; or
 - (c) The function does not apply a systematic and disciplined approach, including quality control. (Ref: Para. A12–A14)

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

15. As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor’s overall audit strategy and audit plan. (Ref: Para. A15–A17)
16. The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly: (Ref: Para. A15–A17)
- (a) The more judgment is involved in:
 - (i) Planning and performing relevant audit procedures; and
 - (ii) Evaluating the audit evidence gathered; (Ref: Para. A18–A19)
 - (b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant; (Ref: Para. A20–A22)
 - (c) The less the internal audit function’s organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
 - (d) The lower the level of competence of the internal audit function.
17. The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor’s sole responsibility for the audit opinion expressed. (Ref: Para. A15–A22)
18. The external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with SLAuS 260,²⁸ communicate how the external auditor has planned to use the work of the internal audit function. (Ref: Para. A23)

²⁸ SLAuS 260, *Communication with Those Charged with Governance*, paragraph 15

Using the Work of the Internal Audit Function

19. If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities. (Ref: Para. A24–A26)
20. The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.
21. The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether:
 - (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;
 - (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and
 - (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed. (Ref: Para. A27–A30)
22. The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:
 - (a) The amount of judgment involved;
 - (b) The assessed risk of material misstatement;
 - (c) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and
 - (d) The level of competence of the function;²⁹ (Ref: Para. A27–A29)and shall include reperformance of some of the work. (Ref: Para. A30)
23. The external auditor shall also evaluate whether the external auditor's conclusions regarding the internal audit function in paragraph 13 of this SLAuS and the determination of the nature and extent of use of the work of the function for purposes of the audit in paragraphs 16–17 of this SLAuS remain appropriate.

Documentation

24. If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:
 - (a) The evaluation of:
 - (i) Whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors;
 - (ii) The level of competence of the function; and
 - (iii) Whether the function applies a systematic and disciplined approach, including quality control;
 - (b) The nature and extent of the work used and the basis for that decision; and

²⁹ See paragraph 16.

(c) The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

Application and Other Explanatory Material

Definition of Internal Audit Function (Ref: Para. 2, 12)

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

Activities Relating to Governance

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

Activities Relating to Risk Management

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

Activities Relating to Internal Control

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
 - Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
 - Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.
 - Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.
- A2. Activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function, nor whether it is performed by the entity or a third-party service provider, are sole determinants of whether or not the external auditor can use the work of the function. Rather, it is the nature of the activities; the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; competence; and systematic and disciplined approach of the function that are relevant. References in this

SLAuS to the work of the internal audit function include relevant activities of other functions or third-party providers that have these characteristics.

- A3. In addition, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this SLAuS, although they may perform control activities that can be tested in accordance with SLAuS 330.³⁰ For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.
- A4. While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:
- To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud. In this regard, SLAuS 315 (Revised)³¹ requires the external auditor to obtain an understanding of the nature of the internal audit function's responsibilities, its status within the organization, and the activities performed, or to be performed, and make inquiries of appropriate individuals within the internal audit function (if the entity has such a function); or
 - Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor.³²

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

Evaluating the Internal Audit Function

Objectivity and Competence (Ref: Para. 13(a)–(b))

- A5. The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function can be used in the circumstances.
- A6. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.
- A7. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments. Factors that may affect the external auditor's evaluation include the following:
- Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments. For example, whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.
 - Whether the internal audit function is free of any conflicting responsibilities, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.

³⁰ See paragraph 8.

³¹ SLAuS 315 (Revised), paragraph 6(a)

³² See paragraphs 13–23.

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

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

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

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

Application of a Systematic and Disciplined Approach (Ref: Para. 13(c))

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

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

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the internal audit function has appropriate quality control policies and procedures, for example, such as those policies and procedures in ISQC 1³³ that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

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

- A12. The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence.
- A13. Consideration of the factors in paragraphs A7, A8 and A11 of this SLAuS individually and in aggregate is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management, this would be considered a significant threat to the function's objectivity unless other factors such as those described in paragraph A7 of this SLAuS collectively provide sufficient safeguards to reduce the threat to an acceptable level.
- A14. In addition, the CA Sri Lanka Code³⁴ states that a self-review threat is created when the external auditor accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the audit. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. The CA Sri Lanka Code³⁵ discusses the prohibitions that apply in certain circumstances and the safeguards that can be applied to reduce the threats to an acceptable level in other circumstances.

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

Factors Affecting the Determination of the Nature and Extent of the Work of the Internal Audit Function that Can Be Used (Ref: Para. 15–17)

- A15. Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established in accordance with SLAuS 300.¹⁵³⁶

³³ Sri Lanka Standard on Quality Control (SLSQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

³⁴ The CA Sri Lanka Code of Ethics for Professional Accountants (CA Sri Lanka Code), Section 290.199

³⁵ CA Sri Lanka Code, Section 290.195–290.200

³⁶ SLAuS 300, *Planning an Audit of Financial Statements*

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

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of SLAuS 600).³⁷

A17. The external auditor's determination of the planned nature and extent of use of the work of the internal audit function will be influenced by the external auditor's evaluation of the extent to which the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the level of competence of the internal audit function in paragraph 16 of this SLAuS. In addition, the amount of judgment needed in planning, performing and evaluating such work and the assessed risk of material misstatement at the assertion level are inputs to the external auditor's determination. Further, there are circumstances in which the external auditor cannot use the work of the internal audit function for purpose of the audit as described in paragraph 14 of this SLAuS.

Judgments in planning and performing audit procedures and evaluating results (Ref: Para. 16(a))

A18. The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor will need to perform more procedures directly in accordance with paragraph 16 of this SLAuS, because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

A19. Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement in accordance with paragraph 16. Significant judgments include the following:

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

Assessed risk of material misstatement (Ref: Para. 16(b))

A20. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need

³⁷ SLAuS 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

to perform more procedures directly in accordance with paragraph 16 of this SLAuS, and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in SLAuS 200,³⁸ the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

- A21. As explained in SLAuS 315 (Revised),³⁹ significant risks require special audit consideration and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, where the risk 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.
- A22. Carrying out procedures in accordance with this SLAuS may cause the external auditor to reevaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether to use the work of the internal audit function and whether further application of this SLAuS is necessary.

Communication with Those Charged with Governance (Ref: Para. 18)

- A23. In accordance with SLAuS 260,⁴⁰ the external auditor is required to communicate with those charged with governance an overview of the planned scope and timing of the audit. The planned use of the work of the internal audit function is an integral part of the external auditor's overall audit strategy and is therefore relevant to those charged with governance for their understanding of the proposed audit approach.

Using the Work of the Internal Audit Function

Discussion and Coordination with the Internal Audit Function (Ref: Para. 19)

- A24. In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:
- The timing of such work.
 - The nature of the work performed.
 - The extent of audit coverage.
 - Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
 - Proposed methods of item selection and sample sizes.
 - Documentation of the work performed.
 - Review and reporting procedures.
- A25. Coordination between the external auditor and the internal audit function is effective when, for example:
- Discussions take place at appropriate intervals throughout the period.
 - The external auditor informs the internal audit function of significant matters that may affect the function.

³⁸ SLAuS 200, paragraph A29

³⁹ SLAuS 315 (Revised), paragraph 4(e)

⁴⁰ SLAuS 260, paragraph 15

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

A26. SLAuS 200⁴¹ discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention.⁴² The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any actual, suspected or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with SLAuS 240.⁴³

Procedures to Determine the Adequacy of Work of the Internal Audit Function (Ref: Para. 21–22)

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

A28. The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph 22, include the following:

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

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

Reperformance (Ref: Para. 22)

A30. For purposes of this SLAuS, reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may be accomplished by examining items already examined by the internal audit function, or where it is not possible to do so, the same objective may also be accomplished by examining sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures

⁴¹ SLAuS 200, paragraphs 15 and A18

⁴² SLAuS 315 (Revised), paragraph A116

⁴³ SLAuS 315 (Revised), paragraph A11 in relation to SLAuS 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

the external auditor may perform in paragraph A28. While it is not necessary for the external auditor to do reperformance in each area of work of the internal audit function that is being used, some reperformance is required on the body of work of the internal audit function as a whole that the external auditor plans to use in accordance with paragraph 22. The external auditor is more likely to focus reperformance in those areas where more judgment was exercised by the internal audit function in planning, performing and evaluating the results of the audit procedures and in areas of higher risk of material misstatement.