INTERNATIONAL STANDARD ON AUDITING 400

RISK ASSESSMENTS AND INTERNAL CONTROL

(This Standard is effective, but will be withdrawn when ISA 315 and 330 become effective)*

CONTENTS

International Standard on Auditing (ISA) 400, "Risk Assessment and Internal Control" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services," which sets out the application and authority of ISAs.

AUDITING

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" are effective for audits of financial statements for periods beginning on or after December 15, 2004.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on obtaining an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk.

2. **The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgment to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.**

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

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

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

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

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

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

(a) "The control environment" which means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:

- The function of the board of directors and its committees.
- Management's philosophy and operating style.
- The entity's organizational structure and methods of assigning authority and responsibility.
- Management's control system including the internal audit function, personnel policies and procedures and segregation of duties.

(b) "Control procedures" which means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Specific control procedures include:

- Reporting, reviewing and approving reconciliations.
- Checking the arithmetical accuracy of the records.
- Controlling applications and environment of computer information systems, for example, by establishing controls over:
- changes to computer programs
- access to data files.
- Maintaining and reviewing control accounts and trial balances.
- Approving and controlling of documents.
- Comparing internal data with external sources of information.
- Comparing the results of cash, security and inventory counts with accounting records.
- Limiting direct physical access to assets and records.
- Comparing and analyzing the financial results with budgeted amounts.

9. In the audit of financial statements, the auditor is only concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statement assertions. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessments and other considerations, will enable the auditor to:

   (a) Identify the types of potential material misstatements that could occur in the financial statements;

   (b) Consider factors that affect the risk of material misstatements; and

   (c) Design appropriate audit procedures.

10. When developing the audit approach, the auditor considers the preliminary assessment of control risk (in conjunction with the assessment of inherent risk) to determine the appropriate detection risk to accept for the financial statement assertions and to determine the nature, timing and extent of substantive procedures for such assertions.

Inherent Risk

11. **In developing the overall audit plan, the auditor should assess inherent risk at the financial statement level. In developing the audit program, the auditor should relate such assessment to material account balances and classes of transactions at the assertion level, or assume that inherent risk is high for the assertion.**

12. To assess inherent risk, the auditor uses professional judgment to evaluate numerous factors, examples of which are:

    At the Financial Statement Level

    - The integrity of management.
    - Management experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.
    - Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.
    - The nature of the entity's business, for example, the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.
    - Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as identified by financial trends and

ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the Account Balance and Class of Transactions Level

- Financial statement accounts likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.
- The complexity of underlying transactions and other events which might require using the work of an expert.
- The degree of judgment involved in determining account balances.
- Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
- The completion of unusual and complex transactions, particularly at or near period end.
- Transactions not subjected to ordinary processing.

Accounting and Internal Control Systems

13. Internal controls relating to the accounting system are concerned with achieving objectives such as:

    - Transactions are executed in accordance with management's general or specific authorization.
    - All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with an identified financial reporting framework.
    - Access to assets and records is permitted only in accordance with management's authorization.
    - Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken regarding any differences.

Inherent Limitations of Internal Controls

14. Accounting and internal control systems cannot provide management with conclusive evidence that objectives are reached because of inherent limitations. Such limitations include:

    - Management's usual requirement that the cost of an internal control does not exceed the expected benefits to be derived.
    - Most internal controls tend to be directed at routine transactions rather than non-routine transactions.

- The potential for human error due to carelessness, distraction, mistakes of judgment and the misunderstanding of instructions.
- The possibility of circumvention of internal controls through the collusion of a member of management or an employee with parties outside or inside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- The possibility that procedures may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.

Understanding the Accounting and Internal Control Systems

15. When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains a knowledge of the design of the accounting and internal control systems, and their operation. For example, an auditor may perform a "walk-through" test, that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk-through tests performed by the auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.

16. The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things:
    - The size and complexity of the entity and of its computer system.
    - Materiality considerations.
    - The type of internal controls involved.
    - The nature of the entity's documentation of specific internal controls.
    - The auditor's assessment of inherent risk.

17. Ordinarily, the auditor's understanding of the accounting and internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:
    (a) Inquiries of appropriate management, supervisory and other personnel at various organizational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions and flow charts;

(b) Inspection of documents and records produced by the accounting and internal control systems; and

(c) Observation of the entity's activities and operations, including observation of the organization of computer operations, management personnel and the nature of transaction processing.

Accounting System

18. **The auditor should obtain an understanding of the accounting system sufficient to identify and understand:**

(a) **Major classes of transactions in the entity's operations;**

(b) **How such transactions are initiated;**

(c) **Significant accounting records, supporting documents and accounts in the financial statements; and**

(d) **The accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.**

Control Environment

19. **The auditor should obtain an understanding of the control environment sufficient to assess directors' and management's attitudes, awareness and actions regarding internal controls and their importance in the entity.**

Control Procedures

20. **The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan.** In obtaining this understanding, the auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether any additional understanding of control procedures is necessary. Because control procedures are integrated with the control environment and the accounting system, as the auditor obtains an understanding of the control environment and the accounting system, some knowledge about control procedures is also likely to be obtained, for example, in obtaining an understanding of the accounting system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled. Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

Control Risk

Preliminary Assessment of Control Risk

21. The preliminary assessment of control risk is the process of evaluating the effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements. There will always be some control risk because of the inherent limitations of any accounting and internal control system.

22. **After obtaining an understanding of the accounting and internal control systems, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.**

23. The auditor ordinarily assesses control risk at a high level for some or all assertions when:

    (a) The entity's accounting and internal control systems are not effective; or

    (b) Evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.

24. **The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:**

    (a) **Is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and**

    (b) **Plans to perform tests of control to support the assessment.**

Documentation of Understanding and Assessment of Control Risk

25. **The auditor should document in the audit working papers**:

    (a) **The understanding obtained of the entity's accounting and internal control systems; and**

    (b) **The assessment of control risk.** When control risk is assessed at less than high, the auditor would also document the basis for the conclusions.

26. Different techniques may be used to document information relating to accounting and internal control systems. Selection of a particular technique is a matter for the auditor's judgment. Common techniques, used alone or in combination, are narrative descriptions, questionnaires, check lists and flow charts. The form and extent of this documentation is influenced by the size and complexity of the entity and the nature of the entity's accounting and internal control systems. Generally, the more complex the entity's accounting

and internal control systems and the more extensive the auditor's procedures, the more extensive the auditor's documentation will need to be.

Tests of Control

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

    (a) Design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and

    (b) Operation of the internal controls throughout the period.

28. Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

29. When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient, to support a control risk assessment at less than a high level.

30. Tests of control may include:

    - Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorized.
    - Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function not merely who is supposed to perform it.
    - Reperformance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

31. **The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more support the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively.**

32. When obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognizes that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

33. In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The auditor may find it necessary, or may prefer, to use computer-assisted audit techniques. The use of such techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerized accounting system.

34. **Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk.** The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Quality and Timeliness of Audit Evidence

35. Certain types of audit evidence obtained by the auditor are more reliable than others. Ordinarily, the auditor's observation provides more reliable audit evidence than merely making inquiries, for example, the auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.

36. In determining the appropriate audit evidence to support a conclusion about control risk, the auditor may consider the audit evidence obtained in prior audits. In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control. **Before relying on procedures performed in prior audits, the auditor should obtain audit**

evidence which supports this reliance. The auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance. The longer the time elapsed since the performance of such procedures the less assurance that may result.

37. **The auditor should consider whether the internal controls were in use throughout the period.** If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period.

38. The auditor may decide to perform some tests of control during an interim visit in advance of the period end. However, the auditor cannot rely on the results of such tests without considering the need to obtain further audit evidence relating to the remainder of the period. Factors to be considered include:

- The results of the interim tests.
- The length of the remaining period.
- Whether any changes have occurred in the accounting and internal control systems during the remaining period.
- The nature and amount of the transactions and other events and the balances involved.
- The control environment, especially supervisory controls.
- The substantive procedures which the auditor plans to carry out.

Final Assessment of Control Risk

39. **Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed.**

Relationship Between the Assessments of Inherent and Control Risks

40. Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

Detection Risk

41. The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level. Some detection risk would always be present even if an auditor were to examine 100 percent of the account balance or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.

42. **The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level.** In this regard the auditor would consider:

    (a) The nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;

    (b) The timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and

    (c) The extent of substantive procedures, for example, using a larger sample size.

43. There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level. Refer to the Appendix to this ISA for an illustration of the interrelationship of the components of audit risk.

44. While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other. Misstatements discovered in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk. Refer to the Appendix to this ISA for an illustration of the interrelationship of the components of audit risk.

45. The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. **Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.**

46. The auditor's assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.

47. **The higher the assessment of inherent and control risk, the more audit evidence the auditor should obtain from the performance of substantive procedures.** When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. **When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion.**

Audit Risk in the Small Business

48. The auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities. However, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures.

Communication of Weaknesses

49. As a result of obtaining an understanding of the accounting and internal control systems and tests of control, the auditor may become aware of weaknesses in the systems. **The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention.** The communication to management of material weaknesses would ordinarily be in writing. However, if the auditor judges that oral communication is

appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

Public Sector Perspective

1. *In respect of paragraph 8 of this ISA, the auditor has to be aware that the "management objectives" of public sector entities may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, government ordinances, and ministerial directives. The source and nature of these objectives have to be considered by the auditor in assessing whether the internal control procedures are effective for purposes of the audit.*

2. *Paragraph 9 of this ISA states that, in the audit of financial statements, the auditor is only concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statement assertions. Public sector auditors often have additional responsibilities, even in the context of their financial statement audits, with respect to internal controls. Their review of the internal controls may be broader and more detailed than in an audit of financial statements in the private sector.*

3. *Paragraph 49 of this ISA deals with communication of weaknesses. There may be additional reporting requirements for public sector auditors. For example, internal control weaknesses found in the financial statement and other audits may have to be reported to the legislature or other governing body.*

Appendix

Illustration of the Interrelationship of the Components of Audit Risk

The following table shows how the acceptable level of detection risk may vary based on assessments of inherent and control risks.

		Auditor's assessment of control risk is:		
		High	Medium	Low
Auditor's assessment of inherent risk	High	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

The shaded areas in this table relate to detection risk.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.