

Auditing Standard

AUS 402
(July 2002)

Risk Assessments and Internal Controls

Prepared by the **Auditing & Assurance Standards Board** of the
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Auditing Standards contain the basic principles and essential procedures identified in bold-type (black lettering) which are mandatory, together with related guidance. For further information about the responsibility of members for compliance with AUSs refer Miscellaneous Professional Statement APS 1.1 "Conformity with Auditing Standards".

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AUDITING STANDARD
AUS 402 “RISK ASSESSMENTS AND INTERNAL CONTROLS”

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Introduction

- .01 The purpose of this Auditing Standard (AUS) is to establish standards and provide guidance on obtaining an understanding of the internal control structure and on audit risk and its components: inherent risk, control risk and detection risk.
- .02 ***The auditor should obtain an understanding of the internal control structure sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.***
- .03 “Audit risk” means the risk that the auditor gives an inappropriate audit opinion when the financial report is materially misstated. Audit risk has three components; inherent risk, control risk, and detection risk.
- .04 “Control environment” means the overall attitude, awareness and actions of management regarding internal control and its importance in the entity.
- .05 “Control procedures” means those policies and procedures in addition to the control environment that management has established to ensure, as far as possible, that specific entity objectives will be achieved.
- .06 “Control risk” means the risk that misstatements 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 on a timely basis by the internal control structure.
- .07 “Detection risk” means 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.
- .08 “Information system” means the methods and records established to identify, assemble, analyse, calculate, classify, record and report the transactions and other events that affect an entity, and to maintain accountability for assets, liabilities, revenues and expenditures.
- .09 “Inherent risk” means 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 there were no related internal controls.

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- .10 “Internal control structure (internal controls)” means management’s philosophy and operating style, and all the policies and procedures adopted by management to assist in achieving the entity’s objectives. The internal control structure extends beyond those matters that relate directly to the financial report and consists of three elements:
- (a) the control environment;
 - (b) the information system; and
 - (c) control procedures.
- .11 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 financial report assertions and to determine the nature, timing and extent of audit procedures for such assertions.
- .12 In a financial report audit, the auditor is only concerned with those internal controls that are relevant to the financial report assertions. The understanding of relevant aspects of the internal control structure, 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 report;
 - (b) consider factors that affect the risk of material misstatements; and
 - (c) design appropriate audit procedures.

Inherent Risk

- .13 ***In developing the audit plan, the auditor should assess inherent risk at the financial report level. In developing the audit program, the auditor should relate this assessment to material account balances and classes of transactions at the assertion level, or assume that inherent risk is high for the assertion.***
- .14 To assess inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:
- At the Financial Report Level*
- (a) the integrity of management;

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- (b) management experience and knowledge and changes in management during the period, for example the inexperience of management may affect the preparation of the financial report of the entity;
- (c) unusual pressures on management, for example circumstances that might predispose management to misstate the financial report, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations;
- (d) 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; and
- (e) 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

- (a) financial report 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;
- (b) the complexity of underlying transactions and other events which might require using the work of an expert;
- (c) the degree of judgement involved in determining account balances;
- (d) susceptibility of assets to loss or misappropriation, for example assets which are highly desirable and movable such as cash;
- (e) the completion of unusual and complex transactions, particularly at or near period end; and
- (f) transactions not subject to ordinary processing.

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The Internal Control Structure

- .15 It is management’s responsibility to maintain an adequate internal control structure. An effective internal control structure assists management in ensuring that, as far as practicable, the conduct of business is orderly and efficient, including:
- (a) fraud, error, or non-compliance with laws and regulations being prevented, or detected and corrected should they occur;
 - (b) assets being safeguarded from unauthorised use or disposition; and
 - (c) financial records and other relevant data bases completely and accurately reflecting the entire operational activities of the entity and permitting the timely preparation of financial information.
- .16 The division of the internal control structure into the three elements identified in AUS 402.10 facilitates discussion of its nature and how it might be considered during an audit. The auditor’s primary interest, however, is not in classifying aspects of the entity’s operations into any particular category, but in understanding how the internal control structure operates and its contribution towards the reduction of control risk. This understanding would be obtained regardless of the strategy proposed for examining specific financial report assertions at the account balance or class of transactions level.

The Control Environment

- .17 The control environment has an important impact on the way business activities are structured, objectives established and risks assessed. It influences the information system and control procedures, not only in their design, but also in the way they work day to day. A strong control environment, together with an appropriate information system and effective control procedures can significantly reduce control risk. A weak or ineffective control environment can undermine the internal control structure to the extent that the auditor is likely to place little, if any, reliance on control procedures. In this case, the auditor needs to conduct a predominantly substantive audit. Strong individual control procedures cannot compensate for a weak control environment, however, they can help to reduce control risk for specific financial report assertions.

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- .18 ***The auditor should obtain an understanding of the control environment sufficient to assess its effectiveness. When conducting this assessment, the auditor should concentrate on the substance of management’s policies, procedures, and related actions rather than their form.*** Management may establish appropriate policies and procedures but not act on them.
- .19 The control environment consists of the following factors:
- (a) *Management’s Philosophy and Operating Style*

Management is responsible for devising and maintaining the internal control structure. In carrying out its supervisory responsibility, management ordinarily reviews the adequacy of internal control on a regular basis to ensure that all significant controls are operating effectively. Management’s philosophy and operating style will greatly influence the control environment. The auditor would consider management’s attitude toward risk-taking, financial reporting and control. Typical indicators of management’s attitude might include the way accounting policies are selected, the systems in place for monitoring and enforcing control procedures, and the conscientiousness with which accounting estimates are developed.
 - (b) *The Organisational Structure*

An entity’s organisational structure provides the framework within which the activities for achieving its objectives are planned, executed, controlled and monitored. Significant aspects of an organisational structure include defining key areas of responsibility and establishing appropriate lines of reporting. An entity’s organisational structure depends, in part, on its size and the nature of its activities. The auditor ordinarily considers such things as:

 - (i) the concentration of responsibility in the hands of one individual, or a few key individuals;
 - (ii) the ability to provide the information flows necessary to manage activities; and
 - (iii) the adequacy of knowledge and experience of key managers.

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(c) *The Assignment of Authority and Responsibilities*

The assignment of authority and responsibility would be appropriate to the entity and its operations. Authority would only be delegated to the extent required to achieve objectives. The auditor ordinarily considers whether:

- (i) delegation of authority is appropriate;
- (ii) risk acceptance is based on sound risk assessment;
- (iii) all personnel understand that they are accountable for activities over which they have responsibility; and
- (iv) there are effective procedures to monitor results.

(d) *Internal Audit*

An effective internal audit can significantly strengthen the control environment. The governing body can delegate its responsibilities for reviewing the internal control structure, monitoring the operations of the information system and control procedures and recommending improvements, to the internal audit function. In order to be effective, internal audit would possess adequate technical skills, knowledge and experience, integrity and objectivity. Direct reporting lines would be established between internal audit and the highest level of management. The internal auditors would also be able to communicate freely with the external auditor, governing body and the audit committee, where one exists.

(e) *The Use of Information Technology*

The use of information technology would be appropriate to the size and complexity of the entity's operations. The effective design, operation and control of information technology can greatly increase the auditor's confidence in the integrity of the information generated by the system. It is the responsibility of management to establish a framework of overall control over the use of information technology. The auditor considers whether policies and procedures have been established to ensure that:

- (i) appropriate segregation of incompatible functions is provided;

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- (ii) computer systems are developed and maintained in an authorised and efficient manner to establish control over changes to application systems, testing, conversion, implementation and documentation of new or revised systems and access to systems documentation;
- (iii) computer systems are used only for authorised purposes and only by authorised personnel;
- (iv) errors are detected before, during and after processing;
- (v) systems software modifications are appropriately authorised, approved, tested, implemented and documented and that access to software and documentation is restricted to authorised personnel; and
- (vi) transactions being entered into computer systems are appropriately authorised and access to data and programs is restricted to authorised personnel.

(f) *Human Resources*

The proper functioning of any system depends upon the competence and honesty of those operating it. The qualifications, selection and training of the personnel involved and their awareness of internal control are important features in establishing and maintaining an effective internal control structure. The auditor ordinarily considers:

- (i) standards for recruiting personnel;
- (ii) training policies;
- (iii) rotation of personnel and promotions driven by performance appraisals; and
- (iv) effective counselling and disciplinary actions.

(g) *The Audit Committee*

The existence of an audit committee can indicate a positive attitude towards internal control, however its effectiveness

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within the business environment can be influenced by a number of factors:

- (i) its mandate and independence from management;
- (ii) the experience of its members;
- (iii) the extent of its involvement in the operations of the entity;
- (iv) the appropriateness of its actions; and
- (v) its interaction with internal audit.

The Information System

.20 ***The auditor should obtain an understanding of the information 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 report; and***
- (d) the accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial report.***

.21 Obtaining an understanding of the information system would require the auditor to obtain an understanding of how the information database is held, up-dated and secured, including supporting documentation.

Control Procedures

.22 Specific control procedures include:

- (a) reporting, reviewing and approving reconciliations;
- (b) checking the arithmetical accuracy of records;
- (c) controlling computer applications and the computer information systems environment, for example, by establishing controls over:

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- (i) changes to computer programs; and
 - (ii) access to data files;
 - (d) maintaining and reviewing control accounts and trial balances;
 - (e) approving and controlling documents;
 - (f) comparing internal data with external sources of information;
 - (g) comparing the results of cash, security and inventory counts with accounting records;
 - (h) limiting direct physical access to assets and records; and
 - (i) comparing and analysing the financial results with budgeted amounts.
- .23 ***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 the information system when determining whether any additional understanding of control procedures is necessary to plan the audit.
- .24 Because some control procedures are integrated in specific components of the control environment and information system, as the auditor obtains an understanding of them, knowledge is also likely to be obtained about control procedures. For example, in obtaining an understanding of the information system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled. Ordinarily, development of the audit plan does not require an understanding of control procedures for every financial report assertion in each account balance and transaction class.

Inherent Limitations of Internal Control Structures

- .25 Internal control structures cannot provide management with conclusive evidence that objectives are reached because of inherent limitations. Such limitations include:
- (a) management’s usual requirement that the cost of an internal control does not exceed the expected benefits to be derived;

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- (b) most control procedures tend to be directed at routine transactions rather than non-routine transactions;
- (c) the potential for human error due to carelessness, distraction, mistakes of judgement and the misunderstanding of instructions;
- (d) the possibility of circumvention of control procedures through the collusion of a member of management or an employee with parties outside or inside the entity;
- (e) 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; and
- (f) the possibility that procedures may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.

Understanding the Internal Control Structure

- .26 The nature and extent of the procedures performed by the auditor to obtain an understanding of the internal control structure will vary with, among other things:
 - (a) the size and complexity of the entity and of its computer system;
 - (b) materiality considerations;
 - (c) the type of internal controls involved;
 - (d) the nature of the entity’s documentation of specific internal controls; and
 - (e) the auditor’s assessment of inherent risk.
- .27 Ordinarily the auditor’s understanding of the internal control structure is obtained through previous experience with the entity and is supplemented by:
 - (a) inquiries of appropriate management, supervisory and other personnel at various organisational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions and flow charts;

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- (b) inspection of documents and records produced as part of the internal control structure; and
 - (c) observation of the entity’s activities and operations, including observation of the organisation of computer operations, management personnel, and the nature of the transaction processing.
- .28 The extent to which an understanding of the information technology controls is required, and the level of skills needed to properly assess those controls, will depend on the extent and complexity of the computer systems and the degree to which key functions of an accounting or control nature are incorporated into computer programs.
- .29 When obtaining an understanding of the internal control structure to plan the audit, the auditor obtains a knowledge of the design of the internal controls and their operation. For example, an auditor may perform a “walk-through” test, that is tracing a few transactions through the information 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. However, the nature and extent of walk-through tests are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment that is less than high.

Control Risk

Preliminary Assessment of Control Risk

- .30 The preliminary assessment of control risk is the process of evaluating the effectiveness of an entity’s internal control structure in preventing or detecting and correcting material misstatements. There will always be some control risk because of the inherent limitations of any internal control structure.
- .31 ***After obtaining an understanding of the internal control structure, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.***
- .32 ***The preliminary assessment of control risk for a financial report assertion should be high unless the auditor:***
- (a) ***is able to identify internal controls relevant to specific assertions which are likely to prevent or detect and correct a material misstatement; and***

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- (b) *plans to perform tests of control to support the assessment.*
- .33 Where control risk is assessed as high, the auditor places emphasis on obtaining audit evidence through the performance of substantive procedures.
- .34 The auditor ordinarily assesses control risk as high for some or all assertions when:
 - (a) the entity’s internal control structure is not effective; or
 - (b) evaluating the effectiveness of internal controls would not be efficient. That is the reduction in substantive procedures would not be sufficient to outweigh the audit effort of performing tests of control.
- .35 The preliminary assessment of control risk is made at the assertion level for each material account balance or class of transactions. When the control environment is weak, the auditor will often assess control risk as high for all assertions except those where strong and independent control procedures mitigate the effect of the weak environment.

Documentation of Understanding and Assessment of Control Risk

- .36 *In accordance with AUS 208 “Documentation”, the auditor should document in the audit working papers:*
 - (a) *the understanding obtained of the entity’s internal control structure; and*
 - (b) *the assessment of control risk.* When control risk is assessed at less than high, the auditor would also document the basis for this.
- .37 Different techniques may be used to document information relating to the internal control structure. Selection of a particular technique is a matter for the auditor’s judgement. Common techniques, used alone or in combination, are narrative descriptions, questionnaires, check lists and flow charts.
- .38 The form and extent of the documentation will be influenced by the size and complexity of the entity and the nature of the entity’s internal control structure. Generally, the more complex the entity’s internal control structure and the more extensive the procedures the auditor has performed, the more extensive the auditor’s

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documentation will need to be. Documentation will also be affected by the particular audit methodology adopted. For example, the assessment of control risk might be documented in terms of reliance on internal control.

Tests of Control

- .39 ***The auditor should obtain audit evidence through tests of control to support any assessment of control risk that is less than high. The lower the assessment of control risk, the more support the auditor should obtain that the internal control structure is suitably designed and operating effectively.*** In addition to testing individual control procedures, the auditor would apply tests of control to aspects of the control environment and the information system.
- .40 Tests of control are performed to obtain audit evidence about the effectiveness of the:
- (a) design of the internal control structure, that is, whether it is suitably designed to prevent or detect and correct material misstatements; and
 - (b) operation of the internal controls throughout the period.
- .41 Evidence of the effective operation of internal controls is generally concerned with how they were applied, the consistency with which they were applied during the audit period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred.
- .42 Tests of control may include:
- (a) inspection of documents supporting transactions and other events to gain audit evidence that the internal controls have operated properly, for example verifying that a transaction has been authorised;
 - (b) inquiries about, and observation of, the internal controls that leave no audit trail, for example determining who actually performs each function not merely who is supposed to perform it; and
 - (c) reperformance of internal controls, for example reconciliation of bank accounts to ensure they were correctly performed by the entity.

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- .43 Although understanding the internal control structure and assessing control risk are discussed separately in this AUS, they may be performed concurrently in an audit. The objective of procedures performed to obtain an understanding of the internal control structure is to provide the auditor with knowledge necessary for audit planning. The objective of tests of control is to provide the auditor with sufficient appropriate audit evidence to confirm the preliminary assessment of control risk. However, procedures performed to achieve one objective may also pertain to the other objective.
- .44 For example, in obtaining the understanding of the internal control structure regarding cash, the auditor may have obtained audit evidence about the performance of bank reconciliations. However, such procedures would not be adequate to support a preliminary assessment of control risk at less than high unless they provide sufficient audit evidence as to both the design and the operating effectiveness of internal controls relevant to a particular financial report assertion.
- .45 ***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 of Audit Evidence

- .46 Audit evidence obtained directly by the auditor provides more assurance than audit evidence obtained indirectly or by reference. For example the auditor might obtain audit evidence about the proper segregation of duties by reviewing system exception reports detailing breaches, or attempted breaches, of computer access levels and privileges, or by observing the individual who applies a control procedure and making inquiries of appropriate personnel. Generally, the auditor’s observation provides more reliable audit evidence than making inquiries about the actions of an individual.
- .47 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.

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- .48 Internal audit reports may prove to be a useful source of audit evidence about the design and operation of the internal control structure, and may often justify a reduction in the extent of procedures performed by the external auditor. In using such reports, the auditor needs to be satisfied that the work of the internal audit function can be used.

Timeliness of Audit Evidence

- .49 In determining the appropriate support for 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 internal control structure 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 internal control.
- .50 ***Before relying on procedures performed in prior audits, the auditor should obtain audit evidence that supports this reliance.*** The longer the time elapsed since the performance of such procedures the less the assurance that may result.
- .51 ***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 transactions and other events of that period.
- .52 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 financial reporting period. Factors to be considered include:
- (a) the results of the interim procedures;
 - (b) the length of the remaining financial reporting period;
 - (c) whether any changes have occurred in the internal control structure during the remaining period;
 - (d) the nature and amount of transactions and other events and balances involved;
 - (e) the control environment, especially management’s philosophy and operating style; and

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(f) the substantive procedures the auditor plans to carry out.

- .53 The auditor may make use of continuous monitoring procedures during the financial reporting period in order to provide support for the control risk assessment. Continuous monitoring procedures are particularly useful where they have been designed into a computer system and provide data direct to the auditor.

Deviations Found in Performing Tests of Control

- .54 The evaluation of the deviations found in performing tests of control may result in the auditor concluding that less reliance than planned may be placed on the internal control tested, and that the assessed level of control risk should be increased. The nature, timing and extent of substantive procedures would be modified accordingly. However, the auditor may identify another control that can be effectively tested to support the preliminary assessment of control risk at less than high for a particular financial report assertion.
- .55 Deviations from prescribed internal controls arise as a result of control failure, which in turn arise as a result of, for example, changes in key personnel, significant seasonal fluctuations in volumes of transactions, or human error. The auditor would make specific enquires regarding these matters, particularly as to the timing of staff or program changes concerning key internal control functions. Tests of control would then appropriately cover such a period of change or fluctuation.

Review of the Preliminary Assessment of Control Risk

- .56 The auditor would consider whether the planned audit procedures are appropriate for the assessed level of control risk for particular financial report assertions. All reductions in the assessed level of control risk would be supported by sufficient appropriate audit evidence. The evaluation of any deviations found in performing tests of control may result in the auditor concluding that less reliance than planned may be placed on certain internal controls, and consequently that the assessed level of control risk be increased for the particular financial report assertions to which they pertain. In this case, the nature, timing and extent of other audit procedures would be modified. ***Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained, the auditor should consider whether the assessment of control risk is confirmed.***

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Relationship Between the Assessments of Inherent and Control Risks

- .57 Management often responds to inherent risk by designing the internal control structure 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 risk 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

- .58 The level of detection risk relates specifically 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 the auditor were to examine 100 percent of the account balance or class of transactions because, for example, most audit evidence is persuasive not conclusive, and the auditor may select an inappropriate audit procedure, misapply an appropriate audit procedure or misinterpret the audit results.
- .59 ***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 acceptable level.*** In this regard the auditor would consider:
- (a) the nature of substantive procedures, for example using tests directed towards independent parties outside the entity rather than tests directed towards 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.
- .60 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

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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. Appendix 1 illustrates the interrelationship of the components of audit risk.

- .61 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.***
- .62 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 instances the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.
- .63 ***The higher the assessment of inherent and control risks the more audit evidence the auditor should obtain from the performance of substantive procedures.*** When both inherent and control risks are assessed at a high level, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptable level. ***When the auditor determines that detection risk regarding a financial report assertion for a material account balance or class of transactions cannot be reduced to an acceptably low level, the auditor should, in accordance with AUS 702 “The Audit Report on a General Purpose Financial Report”, express a qualified opinion.***

Internal Control in the Small Business

- .64 The auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial reports of both small and large entities. However, many internal controls that would be relevant to large entities would not be practical in small entities. For example in small entities, accounting procedures may be performed by few persons. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by owner/manager supervisory controls which may exist because of direct personal knowledge of the business and involvement in transactions. In circumstances where segregation of

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duties is limited and evidence of supervisory controls is lacking, the auditor is likely to assess the level of control risk as high, and the evidence necessary to support the auditor’s opinion on the financial report would therefore have to be obtained entirely through the performance of substantive procedures.

Operative Date

- .65 This AUS, which incorporates amendments made by AUS/AGS Omnibus 3 “Miscellaneous Amendments to AUSs and AGSs”, is operative from July 2002. This version of AUS 402 supersedes AUS 402 “Risk Assessments and Internal Controls”, as issued in October 1995.

Compatibility with International Standards on Auditing

- .66 Except for the matter noted below, the basic principles and essential procedures of this AUS and of International Standard on Auditing ISA 400, Risk Assessments and Internal Control, are consistent in all material respects:

ISA 400 contains a paragraph including a basic principle/essential procedure regarding communication of weaknesses in internal control. Although this AUS does not have a corresponding paragraph, this matter is addressed in AUS 710 “Communicating with Management on Matters Arising from an Audit”.

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APPENDIX I

ILLUSTRATION OF THE INTERRELATIONSHIP OF THE COMPONENTS OF AUDIT RISK

As indicated in this AUS, the assessment of detection risk relates directly to the nature, timing and extent of substantive procedures. Therefore the lower the assessment of detection risk, the more audit evidence the auditor obtains to support the assessment.

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 is:	High	Low	Low	Medium
	Medium	Low	Medium	High
	Low	Medium	High	High

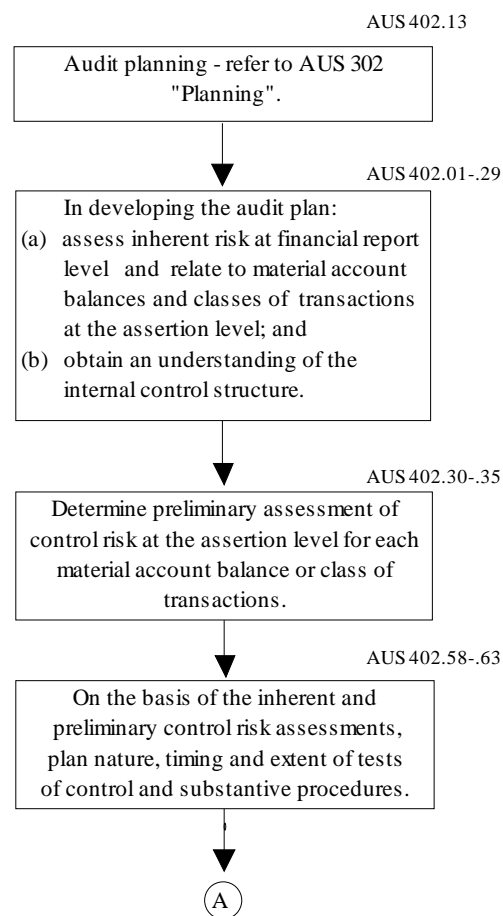
There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks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

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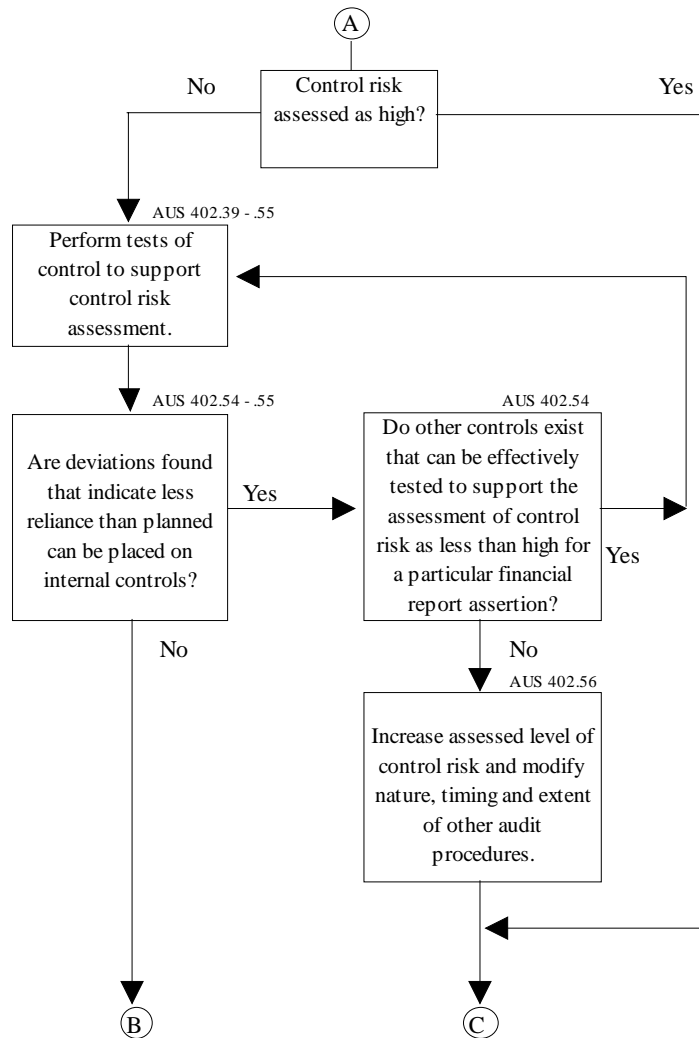
APPENDIX 2

FLOWCHART REFLECTING THE LOGIC OF AUS 402

This flowchart is illustrative of the logic of AUS 402 only. It does not include all the basic principles and essential procedures identified in AUS 402.



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