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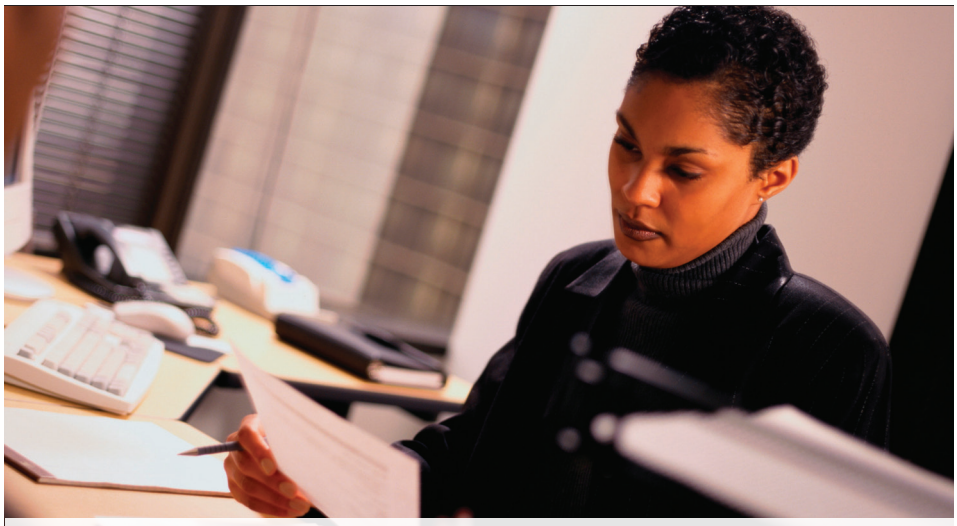
The Bulletin is intended to help raise practitioners' awareness in a timely manner of significant new or emerging issues or other noteworthy circumstances related to engagements addressed by the AASB pronouncements. It is also meant to direct practitioners to relevant requirements, application and other explanatory material in the CICA Handbook – Assurance.



auditing and assurance BULLETIN

FOR PUBLIC ACCOUNTANTS PERFORMING AUDIT AND REVIEW ENGAGEMENTS

Understanding Internal Control Relevant to the Audit — The Function of a Walk-through

Auditors are responsible for understanding the entity's internal control relevant to the audit, in order to achieve their objective of identifying and assessing the risks of material misstatement at the financial statement and assertion levels. This Bulletin responds to matters raised by provincial practice inspectors and practice advisors relating to how auditors are obtaining an understanding of internal control relevant to the audit — in particular, the required depth of that understanding. A walk-through is not a required procedure. However, auditors may use a walk-through to help obtain the required understanding of internal control. In this context, there is evidence that some auditors are

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confused as to the function of a walk-through. This Bulletin explains some specific requirements in the Canadian Auditing Standards (CASs) that deal with obtaining an understanding of internal control and how a walk-through might be used to meet those requirements.

This Bulletin covers the following topics:

- whether the auditor needs to obtain an understanding of internal control on every audit;
- what "relevant" controls are;
- the required depth of understanding of relevant controls;
- how the auditor obtains the required depth of understanding of relevant internal controls; and
- the function of a walk-through.

Is an understanding of internal control needed on every audit?

Yes. The auditor is required to 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. Paragraph 12 of CAS 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, requires the auditor to obtain an understanding of internal control relevant to the audit. Obtaining this understanding of internal control applies to all audits, even when an auditor does not intend to place reliance on internal controls, often the approach taken by auditors of a small entity. When the auditor intends to rely on relevant controls, paragraph 8 of CAS 330, *The Auditor's Responses to Assessed Risks*, requires the auditor to design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls.

What are "relevant" controls?

The auditor is required to obtain an understanding of only those controls that are relevant to the audit. Usually, controls relevant to the audit relate to financial reporting. However, not all controls that relate to financial reporting are relevant to the audit. Paragraph A68 of CAS 315 lists factors that may help an auditor judge whether a control is relevant to the audit:

- 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; and
- whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

In the CASs, the term "controls" refers to any aspects of one or more of the components of internal control and is used in a number of contexts in the requirements in CAS 315. For example:

- paragraph 13 of CAS 315 refers to "controls that are relevant to the audit";
- paragraph 14 refers to the "control environment";
- paragraph 20 refers to "control activities relevant to the audit"; and
- paragraph 22 refers to "major activities that the entity uses to

monitor internal control relevant to financial reporting."

What is the required depth of understanding?

As part of understanding the controls relevant to the audit, paragraph 13 of CAS 315 requires an auditor to:

- *Evaluate the design of those controls* — Paragraph A73 of CAS 315 indicates that 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. Further, 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.
- *Determine whether those controls have been implemented* — Paragraph A73 of CAS 315 explains that implementation of a control means that the control exists and that the entity is using it. Determining whether a control was implemented only provides evidence about whether a control was in operation at a particular point in time; it does not mean that a control is operating effectively throughout the period being audited. Testing of operating effectiveness is necessary when the auditor wishes to place reliance on a control in determining the nature, timing and extent of substantive procedures. Therefore, determining that a control was implemented is not sufficient for an auditor to reduce the nature, timing and extent of substantive procedures.

How does the auditor obtain the required depth of understanding?

Paragraph A74 of CAS 315 explains that risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls include:

- inquiring of the entity's personnel;
- observing the application of specific controls;
- inspecting documents and reports; and
- tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes. Accordingly, in addition to inquiry, an auditor employs some or all of the other risk assessment procedures noted above when obtaining audit evidence about the design and implementation of a control. The tracing of transactions through the information system relevant to financial reporting is often called "a walk-through".

What is the function of a walk-through?

In its simplest form, a walk-through involves:

- following a transaction from its origin through the entity's information systems, until it is reflected in the entity's financial records; and
- using the same documents and information technology that the entity's personnel use.

Walk-throughs are often used by auditors to confirm their understanding of the information system (for example, to corroborate system flow charts or memoranda developed through inquiry of the entity's personnel). A walk-through may assist in identifying sources of potential misstatement not otherwise identified by the auditor when obtaining an understanding of the entity and its environment.

A walk-through may go beyond simply tracing transactions through the information system to also incorporate the other risk assessment procedures referred to in paragraph A74 of CAS 315 (i.e., inquiry, observation and inspection of relevant documentation). If used in conjunction with these types of procedures, a walk-through is recognized as an effective way of performing risk assessment procedures to obtain audit evidence about the design and implementation of controls (in the different contexts the terms "controls" and "internal control" are used in CAS 315). A walk-through does not provide evidence that a control relevant to the audit is operating effectively.

In addition, a walk-through may be used by auditors to:

- provide a basis for deciding whether to test the operating effectiveness of a control so that it can be relied upon when determining the nature, timing and extent of substantive procedures;
- aid in designing effective substantive procedures;
- act as the first test of transactions in a sample;
- obtain useful information regarding entity-level controls (i.e., controls that are pervasive in nature and do not address particular transaction cycles but may prevent or detect and correct misstatements in several transaction cycles); for example:
  - a high degree of involvement of senior management in a smaller entity may be an important entity-level control over both

revenues and expenditures transaction cycles; and
  - o an auditor may be able to use a walk-through in conjunction with inquiry and observation of senior management to obtain an understanding of such a control);
- provide an opportunity to ask probing questions of the entity's personnel beyond a narrow focus on the single transaction used as the basis for the walk-through; and
- provide an opportunity to discuss potentially sensitive matters (such as fraud risk factors related to the particular type of transaction that is the focus of the walk-through) with the entity's personnel in a non-confrontational manner.

Information obtained from a walk-through in the prior year may be carried forward to aid in designing a walk-through in the current year. A walk-through may be performed in the current year to determine whether changes have occurred that may affect the relevance of prior information for the purposes of the current audit.

An auditor may use a walk-through while recognizing the following:

- It may not necessarily provide audit evidence relating to all assertions. For example, inspecting a document during a walk-through may not necessarily provide audit evidence about ownership and value. Therefore, it is important for the auditor to be clear as to which assertions are being addressed by a walk-through.
- The audit evidence provided by a walk-through may be of limited value in certain circumstances. For example, the entity's personnel may act differently when they know that they are being observed by an auditor.
- A walk-through needs to be performed by an auditor with the appropriate expertise and experience. In some cases (for example, complex or high-risk areas), a walk-through may not be effective unless performed by senior engagement staff. Also, when information systems are highly computerized, a walk-through may need to be performed by an auditor with information technology expertise and experience.

Conclusion

This Bulletin explains the requirements in the CASs for auditors to understand internal control. The understanding required involves both evaluating the design and determining the implementation of controls relevant to an audit. It reminds auditors that these requirements apply to all audits, even when the auditor does not intend to place reliance on internal controls. Although not required, a walk-through is often used to confirm the auditor's understanding of an entity's information system. It can be particularly effective as a risk assessment procedure for obtaining audit evidence about the design and implementation of controls.