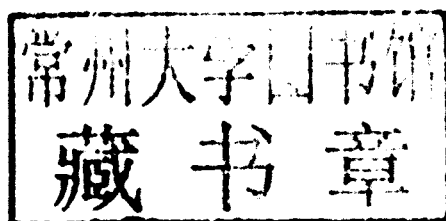


Application Materials of China Standards on Auditing and Quality Control

2010 Edition

The Chinese Institute of Certified Public Accountants



经济科学出版社

图书在版编目 (CIP) 数据

中国注册会计师执业准则应用指南. 2010: 英文/
中国注册会计师协会编著. —北京: 经济科学出版社,
2011. 7

ISBN 978 - 7 - 5141 - 0771 - 5

I. ①中… II. ①中… III. ①注册会计师 - 会计准则 -
中国 - 指南 - 英文 IV. ①F233. 2 - 62

中国版本图书馆 CIP 数据核字 (2011) 第 112916 号

责任编辑: 龚 勋

责任校对: 徐领柱 刘 昕

版式设计: 代小卫

技术编辑: 王世伟

**Application Materials of China Standards on Auditing and Quality Control
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经济科学出版社出版、发行 新华书店经销

社址: 北京市海淀区阜成路甲 28 号 邮编: 100142

总编辑部电话: 88191217 发行部电话: 88191540

网址: [www. esp. com. cn](http://www.esp.com.cn)

电子邮件: [esp@ esp. com. cn](mailto:esp@esp.com.cn)

北京中科印刷有限公司印装

880 × 1230 16 开 28 印张 1400000 字

2011 年 7 月第 1 版 2011 年 7 月第 1 次印刷

ISBN 978 - 7 - 5141 - 0771 - 5 定价: 68.00 元

(图书出现印装问题, 本社负责调换)

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**Notice of the Chinese Institute of Certified Public Accountants on
Promulgating “Application Material of China Standard on
Auditing 1101 – Overall Objectives of the Auditor and the
Conduct of an Audit in Accordance with China Standards on
Auditing” and 37 Other Application Materials**

Kuai Xie [2010] No. 94

To the Institutes of Certified Public Accountants of Provinces, Autonomous Regions, and Centrally Governed Municipalities,

“China Standard on Auditing 1101 – Overall Objectives of the Auditor and the Conduct of an Audit in Accordance with China Standards on Auditing” and 37 other Standards have been approved and promulgated by Ministry of Finance on November 1, 2010, and will become effective from January 1, 2012. In order to assist Certified Public Accountants (CPAs) in understanding and implementing these Standards, the Chinese Institute of Certified Public Accountants (CICPA) has developed “Application Material of China Standard on Auditing 1101 – Overall Objectives of the Auditor and the Conduct of an Audit in Accordance with China Standards on Auditing” and 37 Other Application Materials. The Application Materials are now promulgated and will become effective from January 1, 2012.

Application Materials provide further explanations, interpretations and examples for important Articles of China Standards on Auditing (CSAs), and provide guidance for CPAs’ better understanding and implementation of CSAs. CPAs shall have an understanding of the entire text of a CSA and its Application Material in order to understand its objectives and to apply its requirements properly.

Accordingly, “Application Material of China Standard on Auditing 1101 – Objective and General Principles Governing an Audit of Financial Statements” and 34 other Application Materials, which were promulgated by Kuai Xie [2007] No. 89 on November 29, 2007, shall be withdrawn on the same date. If there are any matters concerning the implementation of these Application Materials, please contact the CICPA.

Attachments:

1. “Application Material of China Standard on Auditing 1101 – Overall Objectives of the Auditor and the Conduct of an Audit in Accordance with China Standards on Auditing” and 37 Other Application Materials
2. The 35 Application Materials to be withdrawn

The Chinese Institute of Certified Public Accountants

November 1, 2010

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Application Materials of China Standards on Auditing

Application Material of China Standard on Auditing 1101

Overall Objectives of the Auditor and the Fundamental Requirements of an Audit

An Audit of Financial Statements

Scope of the Audit (Ref: Article 18)

1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. However, applicable law or regulation may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While such matters may be relevant to forming an opinion on the financial statements and the China Standards on Auditing (hereinafter "CSAs") and Application Materials may include certain requirements and guidance in relation to such matters, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

Preparation of the Financial Statements (Ref: Article 19)

2. Law or regulation may establish the responsibilities of management and, where appropriate, those charged with governance in relation to financial reporting. However, the extent of these responsibilities, or the way they are described, may differ. Despite these differences, an audit in accordance with CSAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have responsibility:

- (a) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- (b) For designing, implementing and maintaining internal control as necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide the auditor with access to all information that is relevant to the preparation of the financial statements, additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit, and unrestricted access to persons within the entity and others from whom the auditor determines it necessary to obtain audit evidence.

3. The preparation of the financial statements by management and, where appropriate, those charged with governance requires:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation of the financial statements in accordance with that framework.
- The inclusion of an adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (i.e., “general purpose financial statements”); or
- The financial information needs of specific users (i.e., “special purpose financial statements”).

5. The applicable financial reporting framework often encompasses financial reporting standards or legislative or regulatory requirements. Other documents may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may include:

- Laws and regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published accounting interpretations of varying authority issued by standards setting organizations;
- Published views of varying authority on emerging accounting issues issued by standards setting organizations; and
- General and industry practices widely recognized and prevalent.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

7. Special purpose frameworks including fair presentation frameworks and compliance frameworks. The term “fair presentation framework” is used to refer to a financial reporting framework that requires management and, where appropriate, those charged with governance to comply with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management and, where appropriate, those charged with governance to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the frame-

work to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires management and, where appropriate, those charged with governance to comply with the requirements of the framework, but do not contain the acknowledgements in (i) or (ii) above.

8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; an income statement; a statement of changes in equity; a cash flow statement; and related notes.

For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements. For example, the International Public Sector Accounting Standard (IPSAS), “Financial Reporting under the Cash Basis of Accounting” issued by the International Public Sector Accounting Standards Board states that the primary financial statement is a statement of cash receipts and payments when a public sector entity prepares its financial statements in accordance with that IPSAS. Other examples of a single financial statement, each of which would include related notes, are:

- Balance sheet;
- Statement of income or statement of operations;
- Statement of retained earnings;
- Statement of cash flows;
- Statement of assets and liabilities that does not include owner’s equity;
- Statement of changes in owners’ equity;
- Statement of revenue and expenses;
- Statement of operations by product lines.

9. CSA 1111 and its Application Material establish requirements and provide guidance on determining the acceptability of the applicable financial reporting framework. CSA 1601 deals with special considerations when financial statements are prepared in accordance with a special purpose framework.

10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain the agreement of management and, where appropriate, those charged with governance that they acknowledge and understand that they have the responsibilities set out in paragraph 2 of this Application Material as a precondition for accepting the audit engagement.

Considerations Specific to Audits in the Public Sector

11. The mandates for audits of the financial statements of public sector entities may be broader than those of other entities. As a result, the premise, relating to management’s responsibilities, on which an audit of the financial statements of a public sector entity is conducted may include additional responsibilities, such as the responsibility

for the execution of transactions and events in accordance with law, regulation or other regulatory authorities.

Form of the Auditor's Opinion (Ref: Article 23)

12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable law or regulation. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation.

Ethical Requirements Relating to an Audit of Financial Statements (Ref: Article 27)

13. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise those requirements related to an audit of financial statements in China Code of Ethics for Certified Public Accountants (hereinafter "the CICPA Code").

14. The CICPA Code No. 1 "Fundamental Principles of Professional Ethics" and No. 2 "Conceptual Framework" establish the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles. The fundamental principles with which the auditor is required to comply by the CICPA Code are:

- (a) Integrity;
- (b) Independence;
- (c) Objectivity;
- (d) Professional competence and due care;
- (e) Confidentiality; and
- (f) Professional behavior.

The CICPA Code No. 3 "Specific Requirements in Providing Professional Services" and No. 4 "Independence Requirements for Audit and Review Engagements" illustrate how the conceptual framework is to be applied in specific situations when auditors perform audit and review engagements.

15. In the case of an audit engagement it is in the public interest and, therefore, required by the CICPA Code, that the auditor be independent of the entity subject to the audit. The CICPA Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

16. China Standard on Quality Control for Firms 5101 “Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements” (CSQC 5101) deals with the accounting firm’s responsibilities to establish and maintain its system of quality control for audit engagements. CSQC 5101 sets out the responsibilities of the accounting firm for establishing policies and procedures designed to provide it with reasonable assurance that the accounting firm and its personnel comply with relevant ethical requirements, including those pertaining to independence. CSA 1121 sets out the engagement partner’s responsibilities with respect to relevant ethical requirements. These include remaining alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team, determining the appropriate action if matters come to the engagement partner’s attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement. CSA 1121 recognizes that the engagement team is entitled to rely on an accounting firm’s system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the accounting firm or other parties suggests otherwise.

Professional Skepticism (Ref: Article 28)

17. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the CSAs.

18. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalizing when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

19. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

20. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if condi-

tions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the CSAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

21. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment (Ref: Article 29)

22. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the CSAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- Materiality and audit risk.
- The nature, timing, and extent of audit procedures used to meet the requirements of the CSAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the CSAs and thereby, the overall objectives of the auditor.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

23. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

24. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the accounting firm, such as that required by CSA 1121, assist the auditor in making informed and reasonable judgments.

25. Professional judgment can be evaluated based on:

- whether the judgment reached reflects a competent application of auditing and accounting principles; and
- whether the judgment is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

26. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in

reaching conclusions on significant matters arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

Audit Evidence and Audit Risk (Ref: Article 20 and Article 30)

Sufficiency and Appropriateness of Audit Evidence

27. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit) or an accounting firm's quality control procedures for client acceptance and continuance.

In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

28. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

29. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

30. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. CSA 1301 and other relevant CSAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

Audit Risk

31. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The

assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

32. For purposes of the CSAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

33. The risks of material misstatement may exist at two levels:

- The overall financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

34. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

35. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

36. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

37. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

38. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk