

DRAFT-PROPOSED INTERNATIONAL STANDARD ON AUDITING 315 (REVISED)

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

MARKED FROM MARCH DRAFT

(Effective for audits of financial statements for periods [beginning/ending] on or after December 15, 2009[XX])

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

FOLLOWING ARE EXTRACTS FROM ISA 315:

Requirements

6. The risk assessment procedures shall include the following:
- (a) Inquiries of management, of ~~the appropriate individuals within the~~ internal audit function (if ~~present~~the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6-A6d)
 - (b) Analytical procedures. (Ref: Para. A7-A10)
 - (c) Observation and inspection. (Ref: Para. A11)

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Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A98-A100)
23. If the entity has an internal audit function,⁺ the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, how the function fits in the entity's organizational structure and the activities performed, or to be performed, in order to determine whether the internal audit function is likely to be relevant to the overall audit strategy and audit plan. (Ref: Para. A101-A103~~ab~~)
24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A104)

Application and Other Explanatory Material

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

- A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity. As obtaining an understanding of the

⁺ ~~The International Standards for the Professional Practice of Internal Auditing define the term "internal auditing" as: "[An] independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."~~

entity and its environment is a continuous, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

A6a. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. For example, in performing their work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on their work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's risk assessments or other aspects of the audit.

~~A6b. [moved to paragraph A6c] Inquiries by the auditor of the internal audit function are made with individuals within the function who have the appropriate knowledge, experience and authority such as the chief internal audit executive.~~

~~A6be. In addition to making inquiries of the appropriate individuals within the internal audit function, If based on responses to the auditor's inquiries, it appears that there are findings that are relevant to the entity's financial reporting and the audit, the auditor may find it useful to examine some of the read related internal audit reports if, based on the auditor's discussions, it appears that there may be findings that are relevant to the entity's financial reporting and the audit.~~

A6c. Appropriate individuals within the function with whom inquiries are made are those who have the appropriate knowledge, experience and authority, such as the chief internal audit executive.

A6d. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. ISA 260² identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

² ISA 260, paragraph 4(b).

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Audit Evidence for Elements of the Control Environment

A71. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

A71a. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified weaknesses in internal control relevant to the audit.

Internal Audit Functions (Ref: Para. 23)

A101. Internal auditing refers to assurance and consulting activities designed to evaluateing and improving the effectiveness of an entity's risk management, internal control, and governance processes.

A102. The objectives of an internal audit function, and therefore the nature of its responsibilities and its status within the organization, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, evaluating and performing procedures to ~~obtain~~provide assurance to management and those charged with governance regarding the design and effectiveness of ~~internal control,~~ risk management, internal control and governance processes and compliance with laws and regulations. ~~On the other hand~~However, the responsibilities of the internal audit function may be limited to ~~the review of~~ the economy, efficiency and effectiveness of operations, for example, and ~~accordingly~~, may not relate to the entity's financial reporting.

A102a. The entity's internal audit function is likely to be relevant to the overall audit strategy and audit plan if the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed. Auditors are more likely to be able to use the work of an entity's internal audit function when it appears, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has a well-established internal audit function (for example, one that is adequately and appropriately resourced, and has a direct reporting relationship to those charged with governance). [moved to paragraph A103b]~~Establishing communications with appropriate individuals within the function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information.~~ If the auditor determines that the internal audit function is likely to be relevant to the overall audit strategy and audit plan, ISA 610 applies.

A103. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6 of this ISA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.

A103a. As is further discussed in ISA 610, the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information. The objective of the internal audit function's assurance activities is to provide assurance about the design and effectiveness of the entity's internal control. Other monitoring controls are often entity-level controls that are designed to contribute to how the entity prevents or detects misstatements.

A103b. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of any significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. ISA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.