

## Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment— [Proposed] International Standard on Auditing 315 (Revised)

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**No Changes Proposed to September 2011 IAASB Meeting Draft]**

(Effective for audits of financial statements for periods ending on or after December 15, 2013)

### CONTENTS

	Paragraph
<b>Introduction</b>	
Scope of this ISA .....	1
Effective Date .....	2
<b>Objective</b> .....	3
<b>Definitions</b> .....	4
<b>Requirements</b>	
Risk Assessment Procedures and Related Activities .....	5-10
The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control .....	11-24
Identifying and Assessing the Risks of Material Misstatement .....	25-31
Documentation .....	32
<b>Application and Other Explanatory Material</b>	
Risk Assessment Procedures and Related Activities .....	A1-A16
The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control .....	A17-A104
Identifying and Assessing the Risks of Material Misstatement .....	A105-A130
Documentation .....	A131-A134
Appendix 1: Internal Control Components	
Appendix 2: Conditions and Events That May Indicate Risks of Material Misstatement	

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.*

[Extracts from ISA 315]

## Requirements

### Risk Assessment Procedures and Related Activities

5. The auditor shall 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. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A5)
6. The risk assessment procedures shall include the following:
  - (a) Inquiries of management, of appropriate individuals within the internal audit function (if 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-A13)
  - (b) Analytical procedures. (Ref: Para. A7-A10)
  - (c) Observation and inspection. (Ref: Para. A11)

### Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to 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,<sup>1</sup> the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A101-A108)
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)

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<sup>1</sup> Paragraph 14 of ISA 610 (Revised), *Using the Work of Internal Auditors*, defines the term "internal audit function" for purposes of the ISAs.

## 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.
- A7. 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 260<sup>2</sup> 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.
  - Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
  - Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.
- A8. As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

### *Inquiries of the Internal Audit Function*

- A9. 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. In performing its 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 its work, such as

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<sup>2</sup> ISA 260, paragraph 4(b)

identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not 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.<sup>3</sup> Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

- A10. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.
- A11. In addition, in accordance with ISA 240,<sup>4</sup> if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.
- A12. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

*Considerations Specific to Audits in the Public Sector* (Ref: Para 6(a))

- A13. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of material deficiencies in internal control over financial reporting.

**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

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<sup>3</sup> The relevant requirements are contained in ISA 610 (Revised), *Using the Work of Internal Auditors*.

<sup>4</sup> ISA 240, paragraph 19

considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

- A72. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

The Entity's Internal Audit Function (Ref: Para. 23)

- A101. If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(a) of this ISA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.
- A102. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.
- A103. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focussed on evaluating the economy, efficiency and effectiveness of operations, and, if so, the work of the function may not directly relate to the entity's financial reporting.
- A104. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) 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.
- A105. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able 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 directly by the auditor in obtaining audit evidence. Auditors

may be more likely to be able to use the work of an entity's internal audit function when it appears for example, based on experience in previous audits or the auditor's risk assessment procedures, that, the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.

- A106. If, based on the auditor's preliminary understanding of the internal audit function, 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, ISA 610 (Revised) applies.
- A107. As is further discussed in ISA 610 (Revised), 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 that are designed to contribute to how the entity prevents or detects misstatements.
- A108. 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 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.