# DRAFT INTERNATIONAL STANDARD ON AUDITING 315

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

(Effective for audits of financial statements for periods beginning on or after December 15, 2009)

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Appendix 1: Internal Control Components

Appendix 2: Conditions and Events That May Indicate Risks of Material Misstatement

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International Standard on Auditing (ISA) 315, “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.”

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Prepared by: Jessie Wong (February 2010)
FOLLOWING ARE EXTRACTS FROM ISA 315:

Requirements

6. The risk assessment procedures shall include the following:

   (a) Inquiries of management, of the internal audit function (if present), 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-A103a)

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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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.

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

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1 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.”
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. 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.

A6c. In addition to making inquiries of the appropriate individuals within the internal audit function, the auditor may find it useful to examine some of the 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.

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 260 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.

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Internal Audit Functions (Ref: Para. 23)

A101. Internal auditing refers to assurance and consulting activities aimed at evaluating 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

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2 ISA 260, paragraph 4(b).
governance. The responsibilities of an internal audit function may include, for example, evaluating and performing procedures to obtain assurance regarding the design and effectiveness of internal control, risk management, and compliance with laws and regulations. On the other hand, 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. [Paragraph A101 in extant ISA] 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). 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.