

## Agenda Item 9-B.2

For reference of the IAASB, the following reproduces the ‘Objective’ and ‘Requirements’ sections of redrafted ISA 315 presented in Agenda Item 9-B, and indicates the following:

- The source paragraph of extant ISA 315 (left-hand column); and
- Proposed new “should” statements (including those that clarify or extend an existing “should” requirement) arising from the review of present tense sentences contained in extant ISA 315. These are highlighted for review purposes.

Paragraph of Extant ISA 315	Redrafted ISA 315 (as per Agenda Item 9-B)
	<p><b>UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT</b></p>
	<p><b>Introduction</b></p>
	<p><b>Scope of this ISA</b></p>
1	<p>1. This International Standard on Auditing (ISA) deals with the auditor’s assessment of the risks of material misstatement in the financial statements. It sets out the objective to be achieved by the auditor, and the requirements that are to be complied with in achieving that objective. The requirements are to be understood and applied in the context of the application material that provides guidance on their application.</p>
	<p><b>Effective Date</b></p>
124	<p>2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 200x.</p>
	<p><b>Objective to Be Achieved</b></p>
2	<p>3. The objective of the auditor in following the requirements of this ISA is to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error.</p>
-	<p>The purpose of making such an assessment is to enable the auditor to design and perform further audit procedures to reduce audit risk to an acceptably low level, as required by ISA 200, “Objective and General Principles Governing an Audit of Financial Statements.”</p>
	<p><b>Definitions</b></p>
30	<p>4. The following terms and related meanings are introduced in this ISA:</p> <p>(a) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.</p> <p>(b) Internal control – The process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and</p>
42, 67, 76,	

81, 84, and 90	<p>efficiency of operations and compliance with applicable laws and regulations. Internal control consists of the following components: (i) the control environment; (ii) the entity’s risk assessment process; (iii) the information system, including the related business processes, relevant to financial reporting, and communication; (iv) control activities; and (v) monitoring controls. The term “controls” refers to one or more of the components, or any aspect thereof.</p>
54 and 121	<p>(c) Material weakness – A weakness in internal control that could have a material effect on the financial statements. A material weakness includes risks of material misstatement that the auditor identifies and which the entity has either not controlled, or for which the relevant control is inadequate, and a weakness in the entity’s risk assessment process that the auditor identifies as material.</p>
45	<p>(d) Owner-manager – The proprietor of an entity who is involved in the running of the entity on a day-to-day basis.</p>
ISA 500	<p>(e) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement whether due to fraud or error at the financial statement and assertion levels.</p>
108	<p>(f) Significant risk – An identified risk of material misstatement that is determined to be, in the auditor’s judgment, a risk that requires special audit consideration.</p>
<p><b>Requirements</b></p>	
<p><b>Risk Assessment Procedures and Activities</b></p>	
-	<p>5. The objective of the following risk assessment procedures and activities is to obtain a satisfactory basis, supported by audit evidence, for making a reliable assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures and activities by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A6)</p>
7	<p>6. The auditor should perform risk assessment procedures and activities <b>that include the following:</b></p>
7a	<p>(a) Inquiries of management and others within the entity who may have information that helps in identifying risks of material misstatement due to fraud or error. (Ref: Para. A7)</p>
7b and 10	<p>(b) Analytical procedures, <b>including the consideration of the results of such analytical procedures along with other information gathered in identifying the risks of material misstatements due to fraud or error.</b> (Ref: Para. A8-A9)</p>
7c and 11	<p>(c) Observation and inspection, <b>including tracing transactions through the information systems relevant to financial reporting as considered appropriate.</b> (Ref: Para. A10)</p>
14 and 16	<p>(d) Discussion with members of the engagement team about the susceptibility of the entity’s financial statements to material misstatements <b>due to fraud or error (with a particular emphasis on fraud), and application of the applicable financial reporting framework to the entity’s facts and circumstances.</b></p>

17 and ISA 240.29	<p>The discussion should involve at least the key members of the engagement team but not all of the members of the engagement team necessarily need to be informed of all of the decisions reached in the discussion. However, the engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion.</p>
19 and ISA 240.32	<p>Throughout the audit, engagement team members should continue to communicate and share information obtained that may affect the assessment of risks of material misstatement due to fraud or error or the audit procedures performed to address these risks. (Ref: Para. A11-A14, and A114)</p>
13	<p>7. The auditor should consider whether information obtained from the auditor's client acceptance or continuance process or from the performance of other audit procedures, or experience gained on other engagements performed for the entity, may be helpful in identifying risks of material misstatement. (Ref: Para. A15)</p>
12	<p>8. For continuing engagements, some of the information used to gain an understanding of the entity may be obtained from the auditor's previous experience with the entity and audit procedures performed in previous audits. When the auditor intends to use such information, the auditor should determine whether changes have occurred that may affect its relevance in the current audit. (Ref: Para. A16-A17)</p>
-	<p><b>The Required Understanding of the Entity and Its Environment, Including Its Internal Control</b></p> <p>9. The objective of the following requirements is to obtain an understanding of those aspects of the entity and its environment, including its internal control, that are generally relevant to the identification and assessment of risks of material misstatement.</p>
22 and 24	<p>THE ENTITY AND ITS ENVIRONMENT</p> <p>10. The auditor should obtain an understanding of the following:</p> <p>(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework and any local regulations that specify certain financial reporting requirements for the industry in which the entity operates. (Ref: Para. A18-A23)</p> <p>(b) The nature of the entity, for example:</p> <ul style="list-style-type: none"> <li>• The entity's operations.</li> <li>• The entity's ownership and governance.</li> <li>• The types of investments that the entity is making and plans to make.</li> <li>• The way that the entity is structured and how it is financed.</li> </ul> <p>An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A24-A26)</p>
25	<p></p>
28	<p>(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should consider whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting</p>

29-32	<p>framework and accounting policies used in the relevant industry. (Ref: Para. A27)</p> <p>(d) The entity's objectives and strategies, and the related business risks that may result in a material misstatement of the financial statements. An understanding of business risks increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks as not all business risks give rise to risks of material misstatement. (Ref: Para. A28-A32, and A115)</p>
35	<p>(e) How management and others measure and review the entity's financial performance, in order to understand business performance. An understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets result in management actions that may have increased the risks of material misstatement, and in particular those due to fraud. (Ref: Para. A33-A37, and A116)</p>
	<p>THE ENTITY'S INTERNAL CONTROL</p>
41	<p>11. The auditor should obtain an understanding of internal control relevant to the audit. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement due to fraud or error, and in designing the nature, timing, and extent of further audit procedures. (Ref: Para. A38-A60, and A117 – A119)</p>
54	<p>12. In order to understand a control, the auditor should evaluate its design and determine whether it has been implemented. 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. Implementation of a control means that the control exists and that the entity is using it. The auditor should do so by performing procedures in addition to inquiry of the entity's personnel, as inquiry alone is not sufficient for such purposes.</p>
55	<p>13. In understanding the entity's internal control relevant to the audit, the auditor should obtain an understanding of the following components of internal control, which are those relevant to the audit:</p>
67	<p>(a) The control environment, which sets the tone of an organization and is the foundation for effective internal control, providing discipline and structure. The understanding should include how management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior, and whether the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and are not undermined by control environment weaknesses.</p>
68	<p>For this purpose, the auditor should understand the following elements of the control environment and how they have been incorporated into the entity's processes:</p> <p>(i) Communication and enforcement of integrity and ethical values.</p> <p>(ii) Commitment to competence.</p>

<p>76</p>	<p>(iii) Participation by those charged with governance.</p> <p>(iv) Management’s philosophy and operating style.</p> <p>(v) Organizational structure.</p> <p>(vi) Assignment of authority and responsibility.</p> <p>(vii) Human resource policies and practices. (Ref: Para. A61-A74, and A120-A121)</p> <p>(b) The entity’s process, whether formal or informal, for:</p> <ul style="list-style-type: none"> <li>• identifying business risks relevant to financial reporting objectives, including risks of fraud in the entity;</li> <li>• estimating the significance of the risks;</li> <li>• assessing the likelihood of their occurrence; and</li> <li>• deciding about actions to address those risks;</li> </ul>
<p>77</p>	<p>and the results thereof. This process is described as the “entity’s risk assessment process” and forms the basis for how management determines the risks to be managed. If the entity’s risk assessment process is appropriate to the circumstances, it assists the auditor in identifying risks of material misstatement.</p>
<p>78</p>	<p>In obtaining this understanding, the auditor should inquire about business risks that management has identified and consider whether they may result in material misstatement. Even if the entity has no formal process, it does not mean that management has not identified and considered the implication of business risks; accordingly, inquiry about identified risks is still relevant in such circumstances. (Ref: Para. A75-A77, and A122)</p>
<p>81</p>	<p>(c) The information system, including the related business processes, relevant to financial reporting. The auditor’s understanding should include the following areas:</p>
<p>82 &amp; 87</p>	<ul style="list-style-type: none"> <li>• The classes of transactions in the entity’s operations that are significant to the financial statements.</li> <li>• The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.</li> </ul>
<p>82 &amp; 87</p>	<ul style="list-style-type: none"> <li>• The related accounting records supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing, correcting as necessary, transferring to the general ledger and reporting transactions.</li> <li>• How the information system captures events and conditions, other than classes of transactions, that are significant to the financial statements.</li> <li>• The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures.</li> </ul>

86	<p>The auditor should consider risks of material misstatement associated with inappropriate override of controls over journal entries and the controls surrounding non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A78-A83, and A123)</p>
89	<p>(d) How the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including communications between management and those charged with governance as well as external communications such as those with regulatory authorities. (Ref: Para. A84 and A124)</p>
90	<p>(e) Control activities relevant to the audit, i.e., those the auditor considers it necessary to understand in order to assess the risks of material misstatement due to fraud or error at the assertion level and to design further audit procedures responsive to assessed risks.</p>
93	<p>In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from information technology (IT) or manual systems. (Ref: Para. A85-A91, and A125-A126)</p>
96	<p>(f) The major types of 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 corrective actions to its controls. In doing so, the auditor should obtain an understanding of the sources of the information related to the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A92-A95, and A127)</p>
	<p><b>Assessing the Risks of Material Misstatement</b></p>
100	<p>14. The auditor should identify and assess the risks of material misstatement due to fraud or error at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures. The objective of this requirement is to identify, and make an assessment of, risks at appropriate levels sufficient for the purpose of designing and perform further audit procedures. (Ref: Para. A96-A102)</p>
100	<p>15. For this purpose, the auditor should:</p> <ul style="list-style-type: none"> <li>• Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and consider the classes of transactions, account balances, and disclosures in the financial statements;</li> <li>• Relate the identified risks to what can go wrong at the assertion level;</li> <li>• Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements, including the possibility that the risks might give rise to multiple misstatements; and</li> <li>• Consider the likelihood that the risks could result in a material misstatement of the financial statements.</li> </ul>
	<p><b>RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION</b></p> <p>16. As part of the risk assessment as described in paragraph 14, the auditor should determine which</p>

<p>108 ISA 240.57</p>	<p>of the risks identified are, in the auditor’s judgment, significant risks. In any case, the auditor should treat those assessed risks that could result in a material misstatement due to fraud as significant risks.</p>
<p>-</p>	<p>The objective of this requirement is to ensure that appropriate attention is given to the more significant risks, and in particular to the risks due to fraud. (Ref: Para. A103-A107)</p>
<p>109</p>	<p>17. The determination of significant risks, which arise on most audits, is a matter for the auditor’s professional judgment. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk to determine whether:</p> <ul style="list-style-type: none"> <li>• the nature of the risk;</li> <li>• the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements; and</li> <li>• the likelihood of the risk occurring</li> </ul> <p>are such that they require special audit consideration.</p>
<p>109</p>	<p>18. In determining which risks are significant risks, the auditor should consider the following:</p> <ul style="list-style-type: none"> <li>• Whether the risk is a risk of fraud.</li> <li>• Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.</li> <li>• The complexity of transactions.</li> <li>• Whether the risk involves significant transactions with related parties.</li> <li>• The degree of subjectivity in the measurement of financial information related to the risk especially those involving a wide range of measurement uncertainty.</li> <li>• Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.</li> </ul>
<p>113</p>	<p>19. For significant risks, the auditor should understand the internal controls relevant to such risks. The objective of this requirement is to provide the auditor with adequate information to develop an effective audit approach. Management ought to be aware of significant risks; however, those risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, although management may have other responses intended to deal with such risks. (Ref: Para. A108-A109)</p>
<p>115</p>	<p><b>RISKS FOR WHICH SUBSTANTIVE PROCEDURES ALONE DO NOT PROVIDE SUFFICIENT APPROPRIATE AUDIT EVIDENCE</b></p> <p>20. In respect of some risks, the auditor may judge that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, such as an entity’s revenue, purchases, and cash receipts or cash payments. In such cases, as part of the risk assessment described in paragraph 14, the auditor should evaluate the design and</p>

<p>119</p> <p>120</p> <p>122</p>	<p>determine the implementation of the entity’s controls, including relevant control activities, over those risks. (Ref: Para. A110-A111)</p> <p><b>REVISION OF RISK ASSESSMENT</b></p> <p>21. The auditor’s assessment of the risks of material misstatement at the assertion level is based on available audit evidence and may change during the course of the audit as additional audit evidence is obtained. <b>In circumstances where the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly.</b> (Ref: Para. A112)</p> <p><b>Communicating With Those Charged With Governance</b></p> <p>22. The auditor should make those charged with governance aware, as soon as practicable, of material weaknesses in the design or implementation of internal control, including in particular those to prevent and detect fraud, which have come to the auditor’s attention. [The objective of this requirement is to provide those charged with governance with information directly arising from the audit that is relevant to their governance roles.]</p> <p><b>Documentation</b></p> <p>23. To meet the documentation requirements of ISA 230, Audit Documentation, in the context of the auditor’s assessment of the risks of material misstatements, the auditor should document:</p> <ul style="list-style-type: none"> <li>(a) The discussion among the engagement team required by paragraph 6(d), and the significant decisions reached;</li> <li>(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 10 and each of the internal control components identified in paragraph 13; the sources of information from which the understanding was obtained; and the risk assessment procedures;</li> <li>(c) The identified and assessed risks of material misstatement <b>due to fraud or error</b> at the financial statement level and at the assertion level as required by paragraph 14; and</li> <li>(d) The risks identified and related controls evaluated as a result of the requirements in paragraphs 19 and 20. (Ref: Para. A113)</li> </ul>