

## **ASA 315**

(October 2009)

# **Explanatory Statement**

## ***ASA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment***

Issued by the **Auditing and Assurance Standards Board**

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**Australian Government**

**Auditing and Assurance Standards Board**

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This Explanatory Statement is available on the Auditing and Assurance Standards Board (AUASB) website: [www.auasb.gov.au](http://www.auasb.gov.au)

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**Reasons for Issuing Auditing Standard ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment***

The Auditing and Assurance Standards Board (AUASB) issues Auditing Standard ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* pursuant to the requirements of the legislative provisions and the Strategic Direction explained below.

The AUASB is as an independent statutory board of the Australian Government established under section 227A of the *Australian Securities and Investments Commission Act 2001*, as amended (ASIC Act). Under section 336 of the *Corporations Act 2001* (the Act), the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislative Instruments Act 2003*.

Under the Strategic Direction given to the AUASB by the Financial Reporting Council (FRC), the AUASB is required to have regard to any programme initiated by the International Auditing and Assurance Standards Board (IAASB) for the revision and enhancement of the International Standards on Auditing (ISAs) and to make appropriate consequential amendments to the Australian Auditing Standards. The IAASB has undertaken a programme to redraft, and in some cases, revise, in “clarity” format, the entire suite of ISAs. Accordingly, the AUASB has decided to revise and redraft the Australian Auditing Standards using the equivalent redrafted ISAs.

**Operative Date**

ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* is operative for financial reporting periods commencing on or after 1 January 2010.

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***Purpose of Auditing Standard ASA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment***

The purpose of the Auditing Standard is to establish Requirements and to provide Application and Other Explanatory Material to auditors regarding the auditor's responsibility to identify and assess the risks of material misstatement in the financial report, through understanding the entity and its environment, including the entity's internal control.

**Main Features**

This Auditing Standard establishes Requirements and provides Application and Other Explanatory Material regarding the auditor's responsibility to identify and assess the risks of material misstatement in the financial report, through understanding the entity and its environment, including the entity's internal control.

This Auditing Standard:

- (a) requires the auditor to perform risk assessment procedures to obtain an understanding of the entity and its environment, and the entity's internal control relevant to the audit;
- (b) requires the engagement team to discuss the susceptibility of the entity's financial report to material misstatements, including those due to fraud or error;
- (c) requires the auditor, where the entity has an internal audit function, to obtain an understanding of that function to determine whether the function has relevance to the audit process;
- (d) requires the auditor to identify and assess the risk of material misstatement at the financial report and assertion levels;
- (e) requires the auditor to use professional judgement in determining whether any of the risks identified represent a significant risk;
- (f) requires the auditor, where the risk of misstatement is significant, or substantive procedures alone do not provide sufficient appropriate audit evidence in respect of an identified risk, to obtain an understanding of the entity's internal controls relevant to the assessed risk;

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- (g) requires the auditor to design, implement, and where appropriate revise, their response to the assessed risks of material misstatement; and
- (h) outlines the documentation requirements of the auditor.

**Preamble and Overall Objectives**

ASA 315 is to be read in conjunction with ASA 101 *Preamble to Australian Auditing Standards*, which sets out the intentions of the AUASB on how the Australian Auditing Standards, operative for financial reporting periods commencing on or after 1 January 2010, are to be understood, interpreted and applied. ASA 315 is to be read also in conjunction with ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*.

**Process of making Australian Auditing Standards**

The AUASB's Strategic Direction, *inter alia*, provides that the AUASB develop Australian Auditing Standards that:

- have a clear public interest focus and are of the highest quality;
- use the International Standards on Auditing (ISAs) of the International Auditing and Assurance Standards Board (IAASB) as the underlying standards;
- conform with the Australian regulatory environment; and
- are capable of enforcement.

In implementing the FRC's Strategic Direction, the AUASB has undertaken a process of revision and redrafting of the Australian Auditing Standards that has:

- updated the form, layout and content of the Australian Auditing Standards;
- addressed the legal enforceability of mandatory obligations;
- maintained clarity of the auditor's obligations;
- incorporated appropriate references to Australian laws and regulations;

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- clearly identified, by use of the prefix “Aus”, AUASB additions to paragraphs in the Requirements or the Application and Other Explanatory Material; and
- included other amendments as necessary.

**Consultation Process prior to issuing the Auditing Standard**

The AUASB has consulted publicly as part of its due process in developing the Auditing Standard. Exposure Draft ED 07/08, *Proposed Auditing Standard: Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, was issued on 31 July 2008 with a 30 day comment period.

As an integral part of its consultation with the public, the AUASB sought comments on specific questions including:

- the completeness and accuracy of references in the Auditing Standard to relevant laws and regulations;
- the significant costs, if any, and benefits, of compliance with any additional Requirements under the Auditing Standard; and
- whether or not there exist any matters of public interest affecting the issuance of the Auditing Standard.

Submissions were received by the AUASB and these were considered as part of the development and finalisation of the Auditing Standard.

**Regulation Impact Statement**

A *Regulation Impact Statement* (RIS) has been prepared in connection with the redrafting of Australian Auditing Standards in Clarity format, including ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*.

The RIS has considered both the expected benefits and expected costs of the introduction of clarified auditing standards, including comments provided by stakeholders during the redrafting process. It concluded that expected benefits to users of audit services, users of audit reports, auditors and the Australian economy in general are, on balance, likely to outweigh expected costs.

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**Main Differences from ASA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (April 2006)**

The main differences between the Auditing Standard and the Auditing Standard that it supersedes, ASA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (April 2006), are:

1. Auditing Standard ASA 315 is written in the 'clarity' format using the equivalent International Standard on Auditing (ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*) as the underlying Auditing Standard. Consequently, the format, layout, and paragraph numbering styles are different from the extant Auditing Standard.
2. The following Requirements included in the Auditing Standard are in part, or full, additional to the extant Auditing Standard:
  - (a) If the entity has not established such a process or has an ad hoc undocumented process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. 17)
  - (b) For this purpose, the auditor shall:
    - (i) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial report;
    - (ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial report as a whole and potentially affect many assertions;

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- (iii) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
  - (iv) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement. (Ref: Para. 25)
- 3. The following requirement in the extant Auditing Standard is included in Auditing Standard ASA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*:
  - (a) The auditor shall make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditor's attention. (Extant Ref: Para. 141)
- 4. To improve clarity, certain requirements and guidance in the extant Auditing Standard have been re-written, however, the equivalent meaning has been retained.
- 5. Certain guidance material in the extant Auditing Standard has been elevated to Requirements.
- 6. Significant Application and Other Explanatory Material, linked to the additional Requirements listed at 2. above is also included in the Auditing Standard.