International Standard on Auditing (ISA) 315 Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatements

The modern business environment is very dynamic and complex – affected significantly by globalisation and technology. This dynamism and complexity directly impacts the quality of audit with reference to appropriateness of conventional auditing procedures and practices to modern environment. Improving and maintaining audit quality by auditors has been of immense concern to all the standard setting bodies as well as regulators throughout the world, including the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

Addressing audit risk appropriately and adequately is undoubtedly an important measure by which the audit quality can be enhanced considerably. Accordingly, the International Auditing and Assurance Standards Board, in the late 2003, issued two new and one revised International Standards on Auditing (ISAs), comprehensively addressing the concept of audit risk. These ISAs are:

- ISA 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
- ISA 330, The Auditor's Procedures in Response to Assessed Risks
- ISA 500 (Revised), Audit Evidence

The issuance of these Standards has also resulted in conforming amendments to a number of other ISAs. This write up deals only with the ISA 315.

An auditor needs to obtain an understanding of the client (entity) and its environment to:

- identify and assess risks of material misstatements at the financial statement and assertion level; and
- design and perform further audit procedures to assess those risks

ISA 315 establishes Standards on:

- how to obtain the above understanding; and
- how to use that understanding in assessing the risks

The Standard, however, is built on the premise that the auditor would need to exercise professional judgment to decide the extent to which the understanding of the entity that he would need to obtain as also the fact that the level of understanding of the entity obtained by the auditor is ordinarily less than that of the management. The extent depends on the sufficiency of the "understanding" to design and perform further audit procedures. The ISA has been divided into five sections –

(i) risk assessment procedures and sources of information about the entity;
(ii) understanding the entity;
(iii) assessing risks of material misstatements;
(iv) communicating with those charged with governance; and
(v) documentation

The first section, Risk Assessment Procedures and Sources of Information About the Entity" dealing with the aspect of risk assessment procedures, is the crux of the Standard on Audit Evidence. The procedures, as per the Standard includes as inquiries of management and others within the entity, analytical procedures, observation and inspection. The section further requires discussion among audit team w.r.t. prior audit experience specific to the entity, findings from audit evidence.

The second section of the ISA which deals with obtaining an understanding of the entity and its environment touches upon crucial areas such as external factors affecting an entity, such as industry specific factors, regulatory factors etc.; nature of the entity, such as its operations, ownership structure, financial reporting framework, business strategies and risk assessment process, review of entity's financial performance etc. The most important aspect discussed in this section is internal controls and its five components – control environment, risk assessment process, information systems, control activities and monitoring activities and the detailed audit procedures related to assessment and evaluation of each of the components of the control system. To summarise, the second section of the ISA is extensively about obtaining the knowledge of the business. The impact on audit procedures of use of information technology in internal controls is also dealt with by the Standard.

The third section of the ISA, Assessing Risk of Material Misstatements, contains a commentary on significant risks that require special audit considerations as also revisions to initial risk assessments. The ISA is also clear on the fact that there might be circumstances where substantive procedures alone would not provide appropriate audit evidence.

While reporting any material weakness in the design or implementation of internal controls, the auditor would need to have regard to the requirements of AAS 27, Communication of Audit Matters with Those Charged with Governance.

The last section of the ISA contains guidance as to the important aspects related to obtaining an understanding of the entity and its environment and risk assessment procedures that need to be documented.

As a matter of policy, the IAASB has also included guidance on the application of this ISA to small and medium entities.

Further, the IAASB would withdraw its following ISAs when ISA 315 becomes effective:

- ISA 310, Knowledge of the Business
- ISA 400, Risk Assessment and Internal Controls
- ISA 401, Auditing in a Computer Information Systems Environment

Effect of ISA 315 on Auditors in Real Terms

A deep and thorough understanding of the client and its environment would invariably be required *vis a vis* as required in ISA 300 since:

(i) the auditors would now also have to go into the aspect of business objectives and strategies as well as the entity's business risk assessment procedure in addition to identifying risks that can affect the financial statements;

(ii) the auditors would now be required to have a thorough understanding of the internal controls as well since now the auditors necessarily have to identify factors that can cause potential misstatements or can affect the risk of material misstatements. This is different from the requirements of ISA 400 which required that in case the auditor's assessment of control risk is high, the auditor would obtain sufficient appropriate audit evidence from substantive procedures and from any audit work carried out in the preparation of financial statements. In other words, the duties of the auditor w.r.t. identification of factors that can cause potential misstatements would remain not withstanding that the auditor does not wish to rely on the entity's internal controls; and

(iii) the need for discussion of susceptibility of the entity to potential risks of material misstatements among the audit team is imperative now and so is detailed documentation of the auditor's procedures.

The above factors have their own implications such as:

- number of staff required to be deputed on a single audit
- need for having more highly experienced and/ or experts/ professional on audit teams
- time and cost per audit would increase considerably

Note

The Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has issued an exposure Draft of the Auditing and Assurance Standard (AASXX) corresponding to the ISA 315. The Exposure Draft has been published elsewhere in the Journal.

(Contributed by the Secretariat of the *Auditing and Assurance Standards Board)*

The views expressed in this write up are those of the secretariat of the Auditing and Assurance Standards Board and do not necessarily represent the views of the Council or any of the Boards/Committees of the Institute of The Chartered Accountants of India. For a complete understanding of IAS 315, please refer the full text thereof as published by IAASB of IFAC.

Invitation for contributing articles

To put the entire gamut of subjects related to audit of listed companies, corporate governance and VAT & Service Tax in perspective, we have decided to bring May 2005 issue of *The Chartered Accountant* on the theme **'Listed Companies Audit and Corporate Governance',** and the June 2005 issue of the journal on the theme **'VAT & Service Tax'.** Experts in the above-mentioned fields are invited to contribute articles for the same.

The articles should not exceed 4,000 words each. Every article should have an Executive Summary of about 150 words, author's e-mail ID, postal address and contact number along with a passport size photograph.

The articles for the **May 2005** issue should reach us by **April 12, 2005** while those for **June 2005** issue should reach us by **May, 10, 2005.**

The articles can be sent to us by e-mail at nadeem@icai.org/ebsecretariat@icai.org or by post (two manuscripts along with a soft copy) to:-

The Editor, The Chartered Accountant, Journal Section, ICAI, PO Box 7100, New Delhi-110002.

Accounting Standard (AS) 15 (revised 2005) Employee Benefits

(The following is a write-upγ containing salient features of Accounting Standard (AS) 15, Employee Benefits and major differences between the revised AS 15 and the existing AS 15. The complete text of the Accounting Standard, which is available on Institute's web site and published in March 2005 issue of the journal, should be referred to for applying the principles of the Accounting Standard.)

Salient features

Accounting Standard (AS) 15, Employee Benefits (revised 2005) prescribes accounting and disclosure for all employee benefits, except employee share-based payments. The applicability date of the revised Standard is not yet specified and the same would be announced by the Council in due course. The Standard identifies four categories of employee benefits:

(a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and

(d) termination benefits.

The Standard requires an enterprise to recognise the undiscounted amount of short-term employee benefits when an employee has rendered service in exchange for those benefits.

Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans. Under defined contribution plans, the enterprise's obligation is limited to the amount that it agrees to contribute to the fund and in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. The Standard requires that when an employee has rendered service to an enterprise during a period, the enterprise should recognise the contribution payable to a defined contribution plan in exchange for that service.

All other post-employment benefit plans are defined benefit plans. Defined benefit plans may be unfunded, or they may be wholly or partly funded. The Standard require an enterprise to:

(a) account not only for its legal obligation under the formal terms, but also for any other obligation that arises from the enterprise's informal practices;

(b) determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date;

(c) use the Projected Unit Credit Method to measure its obligations and related costs;

(d) attribute benefit to periods of service under the plan's benefit formula, unless an employee's service in later years will lead to a materially higher level of benefit than in earlier years;

(e) use unbiased and mutually compatible actuarial assumptions about demographic assumptions (such as, mortality, employee turnover) and financial assumptions (such as discount rate, future salary and benefit levels). Financial assumptions should be based on market expectations, at the balance sheet date, for the period over which the obligations are to be settled;

(f) determine the discount rate by reference to market yields at the balance sheet date on government bonds of a currency and term consistent with the currency and estimated term of the post-employment benefit obligations;

(g) deduct the fair value of any plan assets from the present value of the defined benefit obligation at the balance sheet date. Certain reimbursement rights that do not qualify as plan assets are treated in the same way as plan assets, except that they are presented as a separate asset, rather than as a deduction from the obligation;

(h) limit the carrying amount of a defined benefit asset so that it does not exceed the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan;

(i) recognise past service cost as an expense on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits are already vested immediately following the introduction of, or changes to, a defined benefit plan, an enterprise should recognise past service cost immediately;

(j) recognise gains or losses on the curtailment or settlement of a defined benefit plan when the curtailment or settlement occurs;

(k) recognise immediately actuarial gains and losses in the statement of profit and loss as income or expense.

The Standard requires a simpler method of accounting for other long-term employee benefits than for post-employment benefits by requiring that past service cost should be recognised immediately.

γ Prepared by the Technical Directorate of the ICAI.

Termination benefits are employee benefits payable as a result of either: an enterprise's decision to terminate an employee's employment before the normal retirement date; or an employee's decision to accept voluntary redundancy in exchange for those benefits. An enterprise should recognise termination benefits as a liability and an expense when, and only when:

(i) the enterprise has a present obligation as a result of a past event;

(ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(iii) a reliable estimate can be made of the amount of the obligation.

On first adopting the Standard, the difference (as adjusted by any related deferred tax) between the liability (on the date of first adoption) in respect of employee benefits other than termination benefits, determined as per this Standard and the liability that would have been recognised at the same date under the enterprise's previous accounting policy, should be adjusted against the opening balance of revenue reserves and surplus.

In respect of expenditure on termination benefits, though the Standard requires immediate expensing; as a transitory measure it is provided that where an enterprise incurs expenditure within three years of this Standard first coming into effect, the enterprise may choose to follow the accounting policy of deferring such expenditure over its pay-back period subject to a maximum of 5 years.

Major differences between revised AS 15 (2005) and existing AS 15 (1995)

The revised AS 15 generally deals with all forms of employee benefits, whereas existing AS 15 deals only with retirement benefits. The major differences between the portion of the revised AS 15 (2005) dealing with retirement benefits and existing AS 15 (1995) are as follows:

Revised AS 15 (2005)	Existing AS 15 (1995)
(a) Deals in detail with actuarial valuation method and actuarial assumptions and provides that discount rate should be determined by reference to market yields at the balance sheet date on government bonds.	(a) Only provides that in respect of gratuity and other defined benefits schemes, the accruing liability should generally be determined on the basis of actuarial valuation.
(b) Provides that where contributions to a defined contribution plan do not fall due wholly within twelve months after the end of the period in which the employees render the related service, they should be discounted using the discount rate specified in the Standard.	(b) Does not contain such a requirement.
(c) Deals with multi-employer plans, state plans and insured benefits in respect of post employment benefits.	(c) Does not specifically deal with this aspect.
(d) Deals with accounting for the obligations which are not legal obligations under the formal term of a defined benefit plan but arise because of enterprise's informal practices.	(d) Does not specifically deal with this aspect.
(e) Provides that the detailed actuarial valuation of the present value of defined benefit obligations may be made at intervals not exceeding three years. However, the most recent valuation is reviewed at the balance sheet date and updated to reflect any material transactions and other material changes in circumstances between the date of valuation and the balance sheet date. Fair value of any plan assets is determined at each balance sheet.	(e) Provides that actuarial valuation should normally be conducted at least once in every three years for determination of the cost incurred. However, where the actuarial valuation are not conducted annually, the actuary's report should specify the contributions to be made during the inter-valuation period.
(f) Deals specifically with a situation where the amount determined in respect of a defined benefit liability as per the Standard is negative (an asset).	(f) Does not specifically deal with this aspect.
(g) Makes a distinction between vested benefits and non-vested benefits in respect of past service costs. Provides that an enterprise should recognise past service cost as an expense on a straight-line basis over the average period until the benefits become vested.	(g) Does not make such a distinction and requires that all past service costs should be recognised as expense immediately.
(h) Deals in detail with components of defined benefit obligations and related expense, recognition and measurement of plan assets, reimbursement rights, return on plan assets, curtailments and settlements, etc.	(h) Does not specifically deal with these aspects.
(i) Elaborate disclosure requirements.	(i) Not so elaborate disclosure requirements.

The major differences between the revised AS 15 (2005) and International Accounting Standard (IAS) 19, Employee Benefits, have been included as an Appendix to the revised Standard.