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## Risk-Based Approach to Audit in International Landscape



## Introduction

A risk-based approach to auditing financial statements involves identifying and assessing the 'risk of material misstatement' (RoMM) and responding to those risks to express an appropriate opinion on whether the financial statements are free from material misstatements. Standards on Auditing (SA) 315 and International Standards on Auditing (ISA) 315 deal with identifying and assessing RoMM. Robust risk identification and assessment by the auditor is the key to conducting quality audits.

## Audit Risk Model

The audit risk model involves understanding the entity and its environment (including internal controls) to identify the 'what could go wrong(s)' in the financial statements and assess the probability and magnitude of misstatement. It also involves the auditors determining whether a control reliance strategy is appropriate.

RoMM comprises inherent risk and control risk, which are assessed as high, medium, or low. Inherent risk is the susceptibility of financial statements to misstatement before considering internal controls, while control risk refers to the risk of internal controls failing to detect or prevent misstatements. Based on the identified and assessed risk, the auditor designs and performs audit procedures responsive to these risks, aiming to reduce the risk of issuing an inappropriate audit opinion (i.e., audit risk) to an acceptably low level. Audit risk is thus the product of the RoMM (which is given and cannot be altered by the auditor) and detection risk (the failure of audit procedures to detect a material misstatement).

## Changes in the International Landscape

In 2003, ISA 315 was issued to improve risk assessment and enhance the design and performance of audit procedures in response to assessed risks, ultimately aiming to enhance audit quality. This standard was the result of a joint audit risk project undertaken by the International Auditing and Assurance Standards Board (IAASB) and the United States Auditing Standards Board and is arguably one of the most significant changes in the audit landscape in recent years. Notably, International Standard on Quality Control - ISQC 1 on Quality Control was introduced around the same time.

Later, ISA 315 was revised in 2009 and subsequently in 2019, with the latest revision applicable for audits of financial statements for periods beginning on or after December 15, 2021. The current SA 315 is based on the 2009 version of ISA 315, and not on the latest version. The National Financial Reporting Authority (NFRA), during its meeting in May 2024, re-emphasized the importance of aligning SAs with global standards, allowing deviations only when there are compelling reasons.

## Key Changes in ISA 315 (2019)

The 2019 revision to ISA 315 was made to address challenges with the previous standard and promote its consistent application. While the audit risk model remains unchanged, the 2019 version provides clarifications to help auditors apply the model effectively to identify and assess RoMM. The revised standard is divided into:

### Main Requirements

Describing what is to be done.

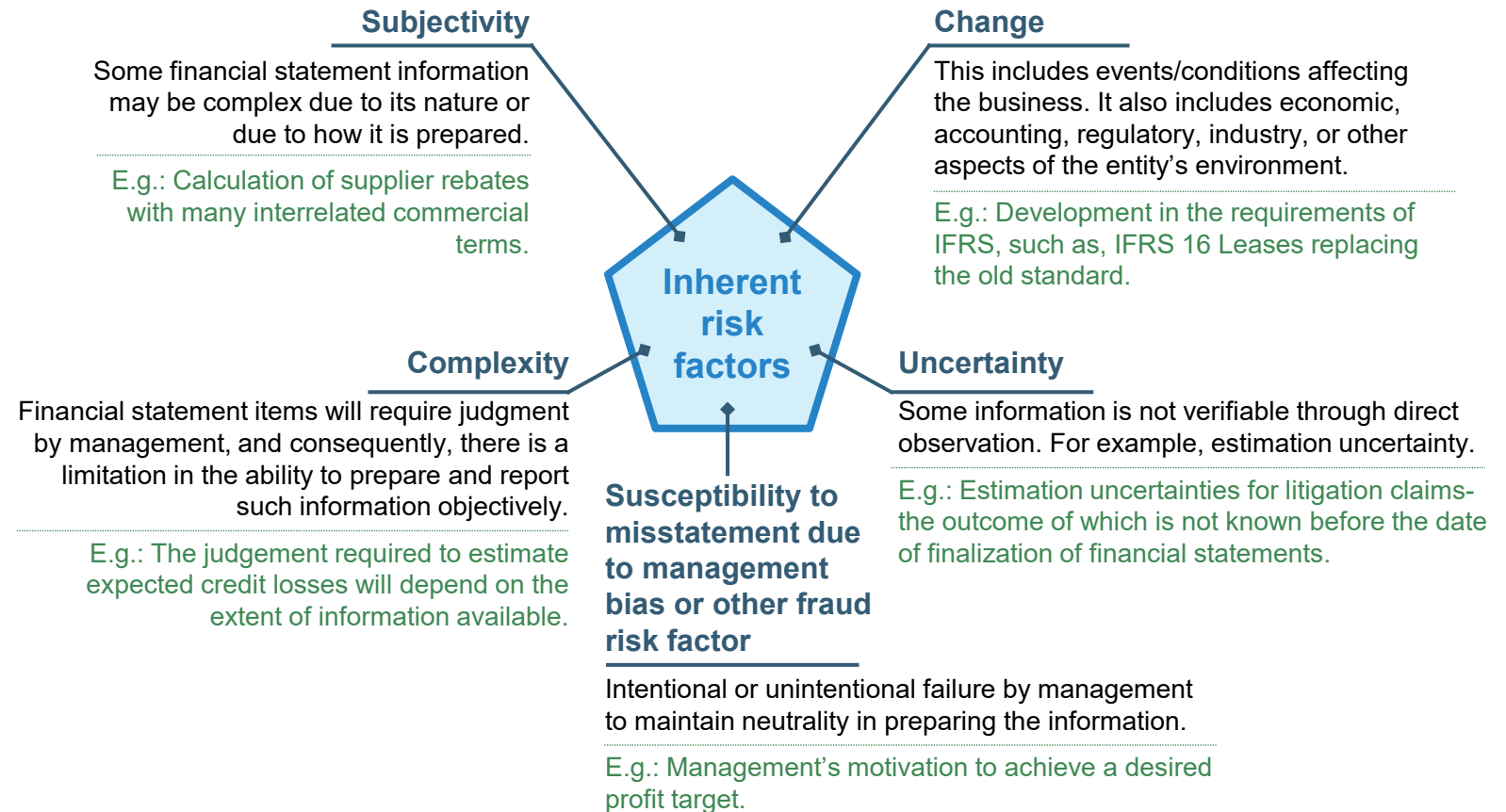
### Application Material

Explaining why and how procedures should be undertaken. The new version is scalable and includes considerations for using automated tools and techniques.

Below are the key highlights:

### Inherent risk factors

The standard defines inherent risk factors as the characteristics of events or conditions that influence susceptibility to misstatement, which can be either qualitative or quantitative. Examples include:



**These requirements promote consistent application of the standard, ensuring a holistic approach to risk identification and improved audit quality.**

## Spectrum of Inherent Risk

Inherent risk varies across assertions, referred to as the 'spectrum of inherent risk.' Professional judgment is required to assess its position on this spectrum, considering factors like the nature, size, and complexity of the entity, as well as the likelihood and magnitude of potential misstatements.

Auditors are now specifically required to obtain more persuasive evidence regarding controls responsive to the risks that are on the higher spectrum.

## Risk assessment process and Significant Risk

Under the 2019 standard, RoMM is still assessed as a product of inherent risk and control risk. This means that the auditor after assessment of inherent risks, can still identify the controls implemented by the management, and if the Control risk, supported by the test of controls, is assessed as low, the RoMM is assessed as low or medium. ISA 315 (2019) reiterates that where the auditor does not plan to test the operating effectiveness of controls, the assessment of RoMM is the same as the assessment of inherent risk.

The concept of Significant Risks i.e. risks that require special consideration, finds a place in the 2019 standard as well. To ensure consistent application, the term significant risk has now been defined to also include identified RoMM for which the assessment of inherent risk is close to the upper end of the spectrum.

ISA 330 deals with audit procedures responsive to significant risks. For instance, if the auditor intends to rely on controls over significant risk, then, the controls need to be tested in the current period. The auditor shall design substantive procedures that are specifically responsive to significant risk. If the approach to significant risk involves only substantive procedures, it shall include a test of details.

It is pertinent to note that auditors must identify the controls that address significant risks. This is regardless of whether the auditor plans a test of controls.

A failure by management to respond to significant risks may indicate a significant control deficiency to be communicated as per the requirements of ISA 265.

According to ISA 260, significant risks are included in the matters communicated with those charged with governance.

## Internal Controls

The standard lays down the distinction between direct and indirect controls, consequently clarifying the extent of work required. It has new and updated appendices for understanding the IT and IT general controls, ensuring modernization.

## Significant Class of Transactions, Account Balances, and Disclosures:

Risk assessment must be performed at both the financial statement level and the assertion level. Engagement teams should also determine significant classes of transactions, account balances, and disclosures, with a mandatory understanding of the entity's information system for such items.

The standard also has a "stand-back" requirement to evaluate if the determination of some material class of transactions, account balances, and disclosures as not significant remains appropriate.

IAASB, with an intention to support the implementation of ISA 315 (2019), has issued a flowchart depicting the iterative nature of risk assessment procedures. The same can be referred to in the annexure to this article.

## Automated Tools and Techniques

The application material in ISA 315 (2019) demonstrates how automated tools and techniques can be utilized to achieve the principal requirements, from simple spreadsheet analyses to complex visualization techniques for analytical procedures.

## Scalability

The standard has been made more scalable through principle-based requirements, which can be applied to audits of entities of varying sizes and complexities. For instance, it recognizes that some owner-managed entities may have processes and systems but with limited documentation. In that case, the auditor can still perform risk assessment procedures through inquiry and observation. Scalability considerations are given under a separate heading within the standard.

Another instance might be an audit of a less complex entity, where the auditor has not identified any significant risks and for which the auditor does not plan to rely on the operating effectiveness of internal controls. In such cases, the auditor may determine that there are no identified controls other than the controls over journal entries.

## Clarifications and enhanced requirements

The 2019 version has enhanced requirements relating to the exercise of professional skepticism along with strengthened documentation requirements. It also includes a separate focus on understanding the applicable financial reporting framework while understanding the entity to identify the risk. It clarifies that risk assessment procedures provide the basis for risk identification and assessment and for the design of responsive audit procedures.



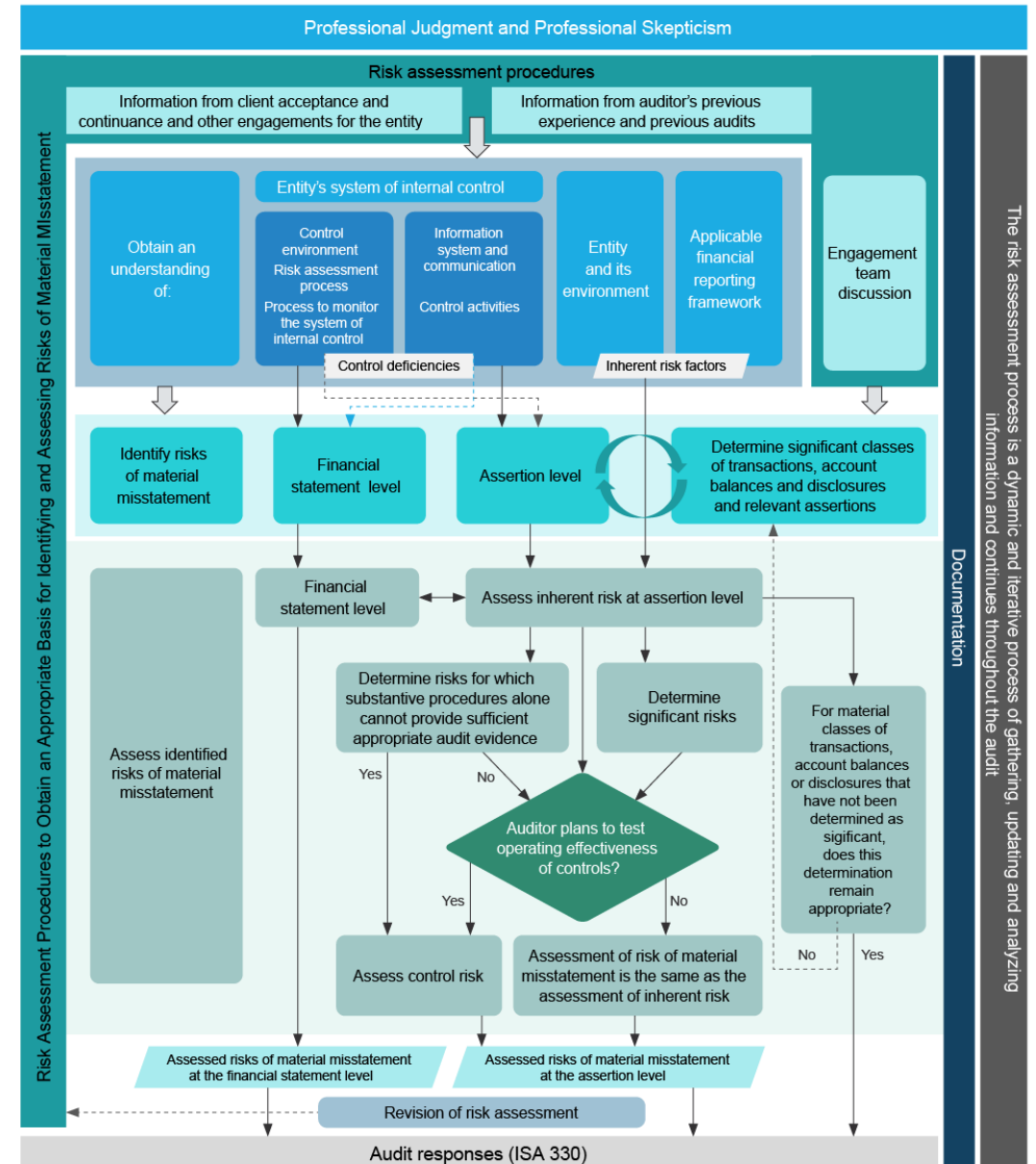


## Conclusion

To reiterate, the audit risk model does not change under ISA 315 (2019), the new standard is an enhanced version of the old ISA 315. Current SA 315 differs from ISA 315 (2019). Introducing these changes in SA 315 will make the risk assessment more robust. This is because ISA 315 (2019) provides principle-based requirements that are scalable and provides detailed application material. It introduces the concept of spectrum of inherent risk which will help in better identification of significant risk. Its application would further improve the process of risk identification and assessment performed by the auditors along with bringing consistency to the process. ISA recognizes the evolving environment and provides application guidance on automated tools and techniques.

## Annexure

Flowchart to explain dynamic and iterative process of risk assessment as appearing in the [IAASB Publication: Introduction to ISA 315 \(Revised 2019\)](#)



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