

REVISION OF ISA 315 (REVISED), IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

[Text subject to approval of project proposal by the IAASB] This document was developed and approved by the IAASB. The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance.

The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

I. Subject

1. This project proposal addresses the revision of ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

II. Background, Project Objectives, Scope, and How The Project Serves the Public Interest

Background

2. The International Auditing and Assurance Standards Board (IAASB) consultations in developing its [Strategy for 2015–2019](#) and related [Work Plan for 2015–2016](#) (the Work Plan) indicated a need for the IAASB to take action to address issues relevant to ISA 315 (Revised). As a result, the Work Plan included a project to gain further understanding of the ISA Implementation Monitoring Project¹ findings related to ISA 315 (Revised), with a Working Group formed in 2016 to commence the activities contemplated by the Work Plan.
3. The ISA 315 (Revised) Working Group (the Working Group) commenced its work in early March 2016 and undertook outreach activities to further inform preliminary thinking on the issues identified involving ISA 315 (Revised). These outreach activities included leadership of the Working Group and staff discussions with representatives of the International Federation of Accountants (IFAC) Small and Medium Practices (SMP) Committee and the International Forum of Independent Audit Regulators' (IFIAR) Standards Coordination Working Group (SCWG).

¹ In 2009, shortly after the clarified ISAs became effective, the Board embarked on a post-implementation review; which was referred to as the "ISA Implementation Monitoring Project". This project focused on obtaining input from a variety of different channels to learn about adoption and implementation issues related to the clarified ISAs. The findings of post-implementation review are discussed in the 2013 publication, [Clarified International Standards on Auditing-Findings from the Post-Implementation Review](#). The IAASB's rigorous outreach program, in particular the strengthened collaboration with IFIARSCWG, and the International Organization of Securities Commissions (IOSCO), as well as ongoing dialogue with audit firms, national auditing standard setters (NSS) and others, continues to keep the IAASB apprised of areas where improvements to the IAASB's standards may be needed, or where other actions to enhance auditor performance may be appropriate.

4. Auditors of small- and medium-sized entities (SMEs) have noted specific challenges from a scalability perspective in effectively and efficiently applying ISA 315 (Revised), in particular around the extent of understanding of internal control that is necessary.
5. Inspection findings by audit regulatory bodies and audit oversight bodies have consistently highlighted issues with respect to auditor's risk assessments, including understanding internal control and consideration of information technology (IT) risk. Inspection findings include inappropriate and insufficient risk assessment procedures, including inadequate involvement of the engagement partner,² the lack of evidence of the auditor's exercise of professional skepticism in the risk assessment process, and concerns over the extent of the auditor's understanding of the entity and its information systems.
6. The IAASB also has other projects on its agenda with linkages to the ISA 315 (Revised) project, including professional skepticism, ISA 220³, ISA 540⁴ and ISA 600.⁵ In discussions related to these other projects, and specifically related to ISA 220, ISA 540 and ISA 600, it was identified that consideration of aspects of the possible revisions to ISA 315 (Revised) would need to be deliberated before those projects are finalized. The specific aspects of ISA 315 (Revised) impacting other projects are included as relevant throughout this Project Proposal. Coordination between the Working Group and the Working Groups and Task Forces of these other projects is set out further in paragraphs 61–72 of this Project Proposal.
7. This project proposal has been formed on the basis of:
 - (a) Outreach activities noted in paragraph 3;
 - (b) Input received from the ISA Implementation Monitoring Project;
 - (c) Discussions and revisions to ISA 315 (Revised) arising from the IAASB's Disclosures project;⁶
 - (d) Input received at the March 2016 IAASB and June 2016 IAASB meetings, and March IAASB Consultative Advisory Group (CAG) meetings;
 - (e) Discussions relating to other IAASB projects as discussed in paragraph 6;
 - (f) Findings from inspections by audit oversight bodies;⁷ and

² The role of the engagement partner is being more broadly explored within the IAASB's Quality Control project.

³ ISA 220, *Quality Control for an Audit of Financial Statements*

⁴ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

⁵ ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

⁶ In July 2015, the IAASB published its changes across ten standards for [Addressing Disclosures in the Audit of Financial Statements – Revised ISAs and Related Conforming Amendments](#) (effective for audits of financial statements for periods ending on or after December 15, 2016). The changes also included amendments to ISA 315 (Revised). Specifically, the revisions to ISA 315 (Revised) included changes to be clear that the understanding of the information system also includes an understanding of how the information system relates to disclosures, and a further emphasis on the fact that certain of this information may be from outside the general and subsidiary ledgers. During the course of its deliberations on these matters, the IAASB was mindful to not inadvertently scope into the requirement the need to obtain a more comprehensive understanding of the system and processes that may not be relevant to the audit, thereby increasing the auditor's work effort unnecessarily. However, during its deliberations the IAASB also recognized that further consideration of these matters during a project to revise ISA 315 (Revised) may be needed.

⁷ [International Forum of Independent Audit Regulators Report on 2015 Survey of Inspection Findings](#)

- (g) The Working Group's discussions to date.
8. The Working Group has also considered and discussed the implications for ISA 315 (Revised) of:
- (a) The significant changes in, and the evolution and increasingly complex nature of, the economic, technological and regulatory aspects of the markets and environments in which companies and audit firms operate; and
 - (b) Recent developments relating to internal control and risk assessment frameworks.⁸
9. Accordingly, it was concluded that a revision of ISA 315 (Revised), and consideration of other outputs, should be undertaken as a matter of priority, recognizing the importance of taking action to respond to the issues identified and, in particular, the importance of being responsive to concerns raised that are relevant to the ISA 220, ISA 540 and ISA 600 projects. In undertaking this work, the IAASB recognizes that not all of the issues and challenges identified in this project proposal are most appropriately addressed through changes to the IAASB's auditing standards. Therefore, consideration will also be given to the most appropriate actions to be taken, including the development of IAASB Staff publications or other non-authoritative guidance (developed by the IAASB or by others (such as NSS)).
10. It is also important that the principles-based nature of ISA 315 (Revised) be preserved so that it continues to remain fit for purpose, drives auditors to perform appropriate risk assessments in diverse circumstances and is able to be applied effectively in audits of all sizes. This project will therefore result in enhancements or clarifications to the requirements and application material in ISA 315 (Revised), with further consideration also given to the organization of the standard to enable it to be effectively applied. While some of the resultant changes will likely be significant, there is no intention to revise the audit risk model.

Project Objectives

11. The project objectives are to:
- (a) Propose revisions to ISA 315 (Revised), establishing more robust requirements and appropriately detailed guidance to drive auditors to perform appropriate risk assessment procedures in a manner commensurate with the size and nature of the entity. It is anticipated that these revisions will focus on enhancing the auditor's approach to understanding the entity and risk assessment activities in light of the changing environment.
 - (b) Determine whether and how ISA 315 (Revised), in its organization and structure, can be modified to promote a more effective risk assessment.
 - (c) Propose consequential amendments to other standards that may be necessary as a result of revisions to ISA 315 (Revised) (such as ISA 220, ISA 240,⁹ ISA 330¹⁰, ISA 540 and ISA 600).¹¹

⁸ For example, the issuance of the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Internal Control–Integrated Framework (2013) and proposed revisions to COSO's Enterprise Risk Management – Integrated Framework (2004).

⁹ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

¹⁰ ISA 330, *The Auditors Responses to Assessed Risks*

¹¹ It is likely that the consequential amendments to ISA 540 and ISA 600 will be dealt with by those Task Forces as appropriate.

- (d) Determine what non-authoritative guidance and support tools should be developed by the IAASB, or others, to supplement revisions to ISA 315 (Revised) thereby aiding its effective implementation. Non-authoritative guidance and support tools may include International Auditing Practice Notes (IAPNs),¹² Staff publications,¹³ project updates, or illustrations / examples to provide assistance on how ISA 315 (Revised) could be applied, in particular to address concerns by auditors of SMEs.

Project Scope

- 12. As evidenced by the input to the ISA Implementation Monitoring Project, consultations on the Work Plan, outreach conducted by the Working Group to date, and the discussions at the IAASB CAG and the IAASB March and June 2016 meetings, there are clear calls for further consideration about the requirements and guidance in ISA 315 (Revised) to enable auditors – auditing entities of all sizes – to effectively perform risk assessments in increasingly complex environments.
- 13. The IAASB believes a revision of ISA 315 (Revised) will be necessary to revise and enhance specific requirements and revise and develop application material, and develop other non-authoritative guidance, to respond to the issues and concerns raised. Such revisions and enhancements will address matters such as the need for ISA 315 (Revised) to:
 - (a) Not only reflect the current business and audit environment, but also be sufficiently adaptable to deal with the rapidly changing business and audit environment (in particular the increased use of technology);
 - (b) Be more effectively applied by auditors in the private and public sectors applying the standard in audits of entities of various sizes;
 - (c) Set an enhanced foundation for other standards that have more specific risk assessment requirements (such as ISA 540 and ISA 600 and ISA 220); and
 - (d) Enhance the application of professional skepticism by auditors in framing their judgments when performing risk assessment procedures.
- 14. The IAASB will also consider whether improvements in the organization, structure and workflow of the standard are necessary to facilitate improvements in effectively and efficiently applying the auditor's risk assessment procedures, in particular in relation to how the standard addresses expectations about the nature and extent of the auditor's understanding of the entity's internal control.

Emphasis on Considerations Relevant to Auditing SMEs

- 15. Several of the matters noted in the ISA Implementation Monitoring project related to challenges experienced by those who perform audits of SMEs, in particular relating to the extent of understanding of internal control that is necessary (internal control is discussed further below). Often, SMEs engage in

¹² IAPNs do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with all ISAs relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

¹³ Staff publications are used to help raise practitioners' awareness of significant new or emerging issues by referring to existing requirements and application material, or to direct their attention to relevant provisions of IAASB pronouncements.

relatively simple business transactions, which means that their audits under the ISAs will generally be less complex.

16. The application and other explanatory material in ISA 315 (Revised) contain a number of considerations specific to the audit of SMEs.¹⁴ Despite this additional guidance, many auditors have still noted challenges with the application of ISA 315 (Revised) to audits of SMEs and have called on the IAASB to do more to demonstrate how the ISAs are scalable. This feedback and other initiatives, such as the Nordic Federation of Accountants' proposal to develop a standard for audits of smaller entities,¹⁵ suggests that the scalability of ISA 315 (Revised) may not be sufficiently clear.
17. The IAASB has the view that it is therefore necessary, in revising ISA 315 (Revised), to give particular attention to considering whether the revised and enhanced requirements and application material will be sufficiently scalable for audits of SMEs. In addition, to help with illustrating the scalability of the standard, other steps (such as the development of specific non-authoritative guidance) will also be considered as appropriate. In this regard, continued dialogue with the IFAC SMP Committee and outreach with other relevant SMP stakeholders will be essential in order to obtain appropriate input at key stages of the project.

Developing Considerations Relevant to the Public Sector

18. Auditors have also noted challenges with the application of ISA 315 (Revised) in audits of public sector entities. The objectives of a financial statement audit in the public sector are often broader than expressing an opinion on whether the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework (FRF). The audit mandate for public sector entities arising from legislation, regulation, ministerial directives, government policy requirements and legislation may result in additional objectives. These objectives may include reporting on non-compliance with regulation, including budgets and accountability frameworks, and/or reporting on the effectiveness of internal control, and may therefore result in additional risks being identified in public sector audits. Further exploration of public sector matters will likely be necessary as the project progresses. The IAASB is an official observer of the INTOSAI¹⁶ Professional Standards Committee's Steering Committee and its Financial Audit Subcommittee. In this regard, dialogue with INTOSAI, in particular its Financial Audit Subcommittee, will continue, to obtain appropriate input at key stages of the project.

How the Project Serves the Public Interest

Enhancing the Auditor's Approach to Risk Assessment in Recognition of the Changing Environment

19. Risk assessment is fundamental to the audit process and is critical for the auditor in designing an audit strategy and approach that will be responsive to the assessed risks of material misstatement. Risk assessment is about understanding what could go wrong and focusing the auditor's work effort on those areas of the financial statements being audited that are more susceptible to risk of material misstatement. Audit risk (a function of the risk of material misstatement and detection risk) is used by auditors to manage

¹⁴ ISA 315 (Revised), paragraphs A17, A23, A48, A52, A56–A57, A84–A86, A88, A93, A95, A101–A102 and A108

¹⁵ The [IAASB has responded](#) to the [Nordic Federation of Accountants'](#) initiative to explore ways to further support small and medium practices promote audits as a valued service for SMEs.

¹⁶ The International Organization of Supreme Audit Institutions (INTOSAI) operates as an umbrella organization for the external government audit community. INTOSAI provides an institutionalized framework for Supreme Audit Institutions (SAIs) to promote development and transfer of knowledge, improve government auditing worldwide and enhance professional capacities, standing and influence of member SAIs in their respective countries.

the overall risk of an audit engagement. Auditors proceed by assessing inherent risk and control risk – collectively the risks of material misstatement – pertaining to an audit engagement, through gaining an understanding of the entity and its environment (including its internal control). Detection risk forms the residual risk after taking into consideration the inherent risk and control risk.

20. A well-informed risk assessment is therefore critical to audit quality. Since ISA 315 was finalized,¹⁷ entities' structures and processes, and the financial reporting frameworks under which their financial statements are prepared, have evolved further and become more complex. In particular, entities are using technology to a much greater extent, entities' ownership and governance structures have become more complex, and the regulatory environment has changed, with an increased focus on enterprise risk management. At the account level, accounting estimates have become more complex (and increasingly involve the use of current values, many of which incorporate future-oriented information), and more information is now included in disclosures. As a result, risk assessments likely need to be more rigorous or more comprehensive. For example, the IAASB's separate project to revise ISA 540 has highlighted a need to look at specific aspects of ISA 315 (Revised) to ensure that the two standards take a consistent approach to risk assessment, with ISA 540 providing additional specificity to how ISA 315 (Revised) is expected to be applied to the auditing of accounting estimates. Enhanced risk assessment procedures, including requiring more granularity and rigor with regard to the required understanding by the auditor of different aspects of how management develops accounting estimates may help auditors to more specifically and precisely identify and assess the risks of material misstatement associated with accounting estimates.
21. The use of data analytics has become more common in today's changing environment. Data analytics enables auditors, in many audits, to gain a better understanding of the areas of risk during the risk assessment phase of the audit. The ability to analyze large populations can enable the auditor to determine and assess the areas of audit risk earlier. For example, tools are available to enable auditors to analyze all transactions in a particular business process for a particular period, allowing the auditor to visualize all the paths transactions took. These tools are increasingly being used to inform the auditor's risk assessment, but the current ISAs do not specifically address the potential benefits and implications of using these tools in an audit of financial statements, including for the purposes of performing risk assessment procedures.
22. Users of the financial statements and the auditor's report expect that auditors, by nature of the access that they have to an entity, are able to design and perform an audit specific to that entity and its industry and that the audit will be appropriately focused on complex and judgmental areas in the financial statements. The IAASB therefore believes it is necessary, and in the public interest, to enhance or clarify specific requirements in ISA 315 (Revised) to address the challenges or issues that have been identified and provide sufficient guidance to enable auditors to enhance their work effort with respect to risk assessment and appropriately tailor their risk assessment based on the nature and size of the entity.

¹⁷ ISA 315 originally became effective for audits of financial statements for periods beginning on or after December 15, 2004. In addition to the revisions to the standard arising from the IAASB's Clarity Project, subsequent revisions to the standard were made as part of the IAASB's work in relation to using the work of internal auditors and addressing disclosures in an audit of financial statements.

Enhancing the Application of Professional Skepticism in Audits

23. Regulators and audit oversight bodies have highlighted concerns about how auditors, in some instances, are performing risk assessment procedures where professional skepticism does not appear to have been appropriately applied. The IAASB commenced a project on professional skepticism¹⁸ in June 2015. In December 2015 the [Invitation to Comment \(ITC\), *Enhancing Audit Quality in the Public Interest—A Focus on Professional Skepticism, Quality Control and Group Audits*](#), sought input in terms of what actions are relevant to enhance the application of professional skepticism in an audit.
24. Feedback on the ITC has highlighted a view that it becomes more difficult for auditors to apply appropriate professional skepticism if they do not have a sufficient understanding of the entity and its environment. Feedback on the ITC also affirmed the importance of auditors exercising professional skepticism in forming auditor judgments as part of planning and performing the audit. Professional skepticism is a fundamental concept and core to audit quality, and it is therefore in the public interest as part of the ISA 315 (Revised) project to explore what should be done to re-emphasize the important role of professional skepticism in to the risk assessment process.

Responding to Other Feedback on Areas for Improvement

25. ISA 315 (Revised) sets out a principles-based approach to risk assessment, with a focus on understanding the entity and its environment, including its internal control. However, as discussed above, feedback from the IAASB's ISA Implementation Monitoring Project, auditors of SMEs and audit oversight bodies have highlighted issues in relation to risk assessment, and the view that the IAASB needs to address such issues in order to enhance audit quality. The issues are described in more detail in the next section of this project proposal.
26. There is particular concern from some stakeholders that there is too much subjectivity in the determination of what is a significant risk in practice, partly resulting from the way that significant risk is defined in ISA 315 (Revised), with a consequential effect on the consistency and extent of work effort to respond to the assessed risks of material misstatement. For example, by not assessing a risk as a significant risk, the auditor may not appropriately address such risks of material misstatement in planning and performing the audit. In turn, failure to properly address a risk of material misstatement may potentially result in either failure to obtain sufficient appropriate audit evidence on which to base the auditor's opinion or one or more unidentified misstatements that might be material, individually or in the aggregate. Issues have also been noted with respect to risk assessment in audits of group financial statements (discussed in further detail in paragraphs 65 and 66). Although these issues will be addressed by the Group Audits Working Group in any revisions to ISA 600, any changes made to the concept of significant risks in this project will be reflected in ISA 600 as appropriate.
27. Practitioners and others have noted that the requirement in ISA 315 (Revised) to obtain an understanding of internal control and control activities "relevant to the audit" which can be difficult to apply in practice. An additional challenge that has been reported is different interpretations by

¹⁸ The IAASB has a project looking at professional skepticism more broadly. For details, see www.iasb.org/projects/professional-skepticism.

auditors of the words ‘before consideration of any related controls’ in the definition of inherent risk.¹⁹ Auditors of SMEs have also questioned the nature and extent of understanding internal control that is necessary if the auditor does not plan to test and rely on controls as part of the audit approach.

28. Feedback from the ITC has indicated the need for the IAASB standards, including ISA 315 (Revised), to address more specifically evolving operational models and related entity structures, such as the use of shared service centers and other evolving business models, and integrated IT systems. Addressing these matters in ISA 315 (Revised) would set an enhanced foundation for the specific requirements relating to risk assessment in ISA 600 for audits of group financial statements. Changes made to ISA 315 (Revised) for these evolving circumstances may also be relevant to the consideration of changes to ISA 220 related to the direction, supervision, performance and review by the engagement partner.
29. Finally, as noted in the ISA 540 project, the relationship between risk assessment and estimation uncertainty, and the concept of management bias, may not be sufficiently clear in ISA 315 (Revised).
30. The IAASB will further consider what revisions, if any, will be necessary to ISA 315 (Revised) to promote audit quality in the varied audit scenarios that arise today, and that are likely to continue to evolve in the future. Furthermore it is important that this is done in a manner that is seen to be responsive to the issues and challenges that have been identified, as well as address the inspection findings that have been consistently noted. In particular, the IAASB will consider how specific requirements in ISA 315 (Revised) could be further enhanced or clarified to drive auditors to perform appropriate risk assessment procedures in the context of processes in place at the entity, including the extent of the entity’s use of technology and the entity’s processes for developing accounting estimates, so that the ISAs are fit for the future, which is in the public interest.

Supporting a Robust, Principles-Based Standard with Additional Guidance to Aid in Its Effective Implementation

31. While revisions to ISA 315 (Revised) are clearly necessary, feedback obtained to date has also indicated that more support (such as the development of non-authoritative guidance by the IAASB) would be helpful to achieve the intended objectives of this project. The IAASB will firstly seek to revise and enhance the requirements so that they are robust, yet sufficiently flexible, to drive appropriate risk assessments. The IAASB will also revise and develop appropriate application and other explanatory material to be included in the revised standard, but recognizes that more specific guidance in particular circumstances (that would not be appropriate to include in a standard intended to apply to audits of all sizes) may be necessary. This could include, for example, guidance on using data analytics in performing risk assessments and illustrative examples of how the risk-based approach to the ISAs could be applied to audits of smaller entities. The development of additional guidance is expected to help with the implementation of the standard and will therefore help drive audit quality, which is in the public interest.

¹⁹ The handbook glossary defines inherent risk as the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Outline of the Project

Major Issues that Will Be Addressed

32. Without pre-judging any matters that the ISA 315 (Revised) Task Force may bring to the IAASB for discussion in the project, the preliminary assessment of the issues that will need to be dealt with in the revision of ISA 315 (Revised) includes the following matters.

Understanding the Entity's Business and its Environment

33. Paragraph 3 of ISA 315 (Revised) states that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. The auditor achieves this objective through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.
34. Paragraph 5 of ISA 315 (Revised) requires the auditor to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. At the assertion level, risks of material misstatement consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.
35. While inherent risk and control risk are defined separately in the audit risk model, auditors may in practice make separate or combined assessments of inherent and control risk depending on their preferred audit techniques or methodologies and practical considerations (paragraph A40 of ISA 200).²⁰ While the assessment may be performed in combination, inherent risk by definition is assessed, and significant risks identified, before the consideration of any related controls. In practice, some auditors find it challenging to not allow the overall knowledge of internal control, the financial reporting process and past experience with the entity to influence the auditor's assessment of inherent risk. The IAASB will consider whether this area of potential ambiguity (i.e., whether the auditor should separately assess inherent risk then control risk, or should assess inherent and control risk together) should be addressed and whether a more explicit approach may be more appropriate.
36. ISA 315 (Revised) currently includes requirements for the auditor to gain an understanding of numerous aspects of the entity and its environment in assessing risk of material misstatement.²¹ ISA 315 (Revised) contains minimal guidance on how auditors use the information obtained in their understanding of the entity and its environment to undertake the identification and assessment of risk. The IAASB will explore whether challenges with identifying and assessing risks of material misstatement result from a lack of clarity on how to document and then apply, or interpret, the information gathered when obtaining an understanding of the entity. This will include exploring whether providing the auditor with factors to consider could improve auditors' identification of the risks and enhance the quality of the auditor's assessment of risk.
37. Such factors may assist auditors in identifying risks of material misstatement by illustrating the root causes of risks that may arise at the level of the financial statements as a whole or at the level of individual elements of information required by the FRF.

²⁰ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

²¹ ISA 315 (Revised), paragraphs 11-24

38. Such factors essentially give rise to the inherent challenges in determining the information required by the FRF and include:
- (a) Complexity: arises when there are many items or relationships among such items that require integration in applying depiction methods to determine information required by the FRF. e.g., using a complex model to determine a fair value, complex patterns of trading in financial instruments or complex supplier relationships for a retailer.
 - (b) Ambiguity: results from a lack of clarity or a degree of vagueness in exactly what is required by the FRF, resolved by making an election or judgment about the appropriate information to include.
 - (c) Change: results in changes in the information required by the FRF from one point in time to another during or between financial reporting periods – this includes changes in the FRF or in the entity and its business model in the context of the environment in which the entity operates.
 - (d) Uncertainty: arises from circumstances not within the control of the preparer of the financial information and that affect the determination of information required by the FRF and relate to the past, present or future condition of a transaction or event.
39. In addition to the factors that drive risk, the skills, competencies and behaviors of people and the likelihood and magnitude of potential misstatement also affect the risk of material misstatement. In exploring revisions to ISA 315 (Revised) to incorporate factors that drive risk, the IAASB will also consider the contextual factors described within the IAASB's [*Framework for Audit Quality*](#).²²
40. An additional issue, that was discussed by the IAASB and resulted in revisions to ISA 315 (Revised) from the Disclosures project, relates to understanding the information relevant to financial reporting that is obtained from outside of the general and subsidiary ledgers, as well as from external data sources that are used in determining estimates. For the latter, it may be difficult to identify when such information becomes part of the entity's information system and to what extent the auditor needs to understand the nature and source of the information.
41. In addition, the IAASB, with input from the IAASB's Data Analytics Working Group (DAWG), will explore the impact of using data analytics when gaining the understanding of the entity and its environment as required by ISA 315 (Revised).

The Risk Assessment Process and Identification of Risks of Material Misstatement

42. ISA 315 (Revised) requires that the auditor identify and assess risks of material misstatement, including those that are significant risks.²³ While not articulated in this manner in current ISA 315 (Revised), the intent of identifying significant risks (those risks that require special audit consideration) is to identify risks that, by their nature, pose a high risk of material misstatement in the financial statements.

²² In February 2014 the IAASB published *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality*. Through this Framework, the IAASB aims to raise awareness of the key elements of audit quality, encourage key stakeholders to challenge themselves to do more to increase audit quality in their particular environments, and facilitate greater dialogue between key stakeholders on the topic.

²³ The handbook glossary defines significant risk as 'an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.'

43. The IAASB will explore whether the significant risk concept in ISA 315 (Revised) is achieving the objective intended, and whether it should remain (with a revised definition focused on the nature of the risk rather than the expected audit response), or whether an approach based on a 'spectrum of risk' should be explored (to acknowledge that there may be a range of risks that may help indicate that 'non-significant' risks are not all equal). Feedback from a variety of stakeholders also suggests that the current definition of significant risk is circular as it focuses on the implication of the risk to the audit (i.e., "requires special audit consideration") rather than the nature of the risk itself.
44. ISA 315 (Revised) also refers to the existence of other risk categories beyond significant risks, for example, "higher risks". The Task Force will explore to what extent distinct categories of risk should be defined or whether the concept of risks of material misstatement existing across a spectrum of risk may be an appropriate response, in seeking to clarify the auditor's assessment of the nature of identified risks.
45. In addition to the matters noted in the ISA Implementation Monitoring Project, questions that arise in practice relevant to ISA 315 (Revised) that will be considered by the IAASB include:
- At what level should the risk assessment be done? At the financial statement line item level or at a level lower than the financial statements (e.g., at the account level)? And whether the concept of identifying significant accounts and disclosures (similar to how this concept exists in the U.S. Public Company Accounting Oversight Board risk standards) may facilitate risk assessment by providing a clearer connection to assessing the risk of material misstatement at the assertion level?
 - Do paragraphs 25 and 26(a) of ISA 315 (Revised) require two risk assessments: one based on the understanding of the entity, and the other based on an assessment of what is included in the financial statements?
 - Is there an over-emphasis in the auditor's response to assessed risks on those risks that have been identified as significant risks, and whether sufficient work effort is therefore performed on those that are not identified as significant risks?
 - Should the number of significant risks increase relevant to the increase in size or complexity of the entity?

Internal Control

46. ISA 315 (Revised) paragraph 12 requires the auditor to obtain an understanding of internal control²⁴ relevant to the audit. The standard utilizes five components of internal control as a framework for auditors to consider how different aspects of an entity's internal control may affect the audit. While ISA 315 (Revised) is framework neutral, the standard is influenced by the COSO Internal Control–Integrated Framework (1992).
47. The IAASB will explore the extent to which obtaining an understanding of each of the five components of internal control in ISA 315 (Revised) is relevant in all audits. Gaining an understanding of some of the five components of internal control in ISA 315 (Revised) may, in principle, be relevant to all audits (e.g., the

²⁴ The handbook glossary defines 'internal control' as 'the process designed, implemented and maintained 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 efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.'

entity's control environment and its information system relevant to financial reporting), but the extent to which other components are relevant to a particular audit may vary. For example, in some audits, where the entity and its systems and processes are less complex, the extent of understanding of control activities may be relatively minimal compared to an entity where there are complex systems and processes.

48. As a result of outreach performed to date, views have been expressed that, in audits of entities of all sizes, the purpose of requiring the auditor to obtain an understanding of internal control relevant to the audit includes to:
- Provide the auditor with further input into understanding the entity's business and assessing risks arising from inadequate internal control;
 - Facilitate the auditor's assessment of whether reliance will be placed on internal control or not (i.e., understanding of internal control is necessary to determine an appropriate audit strategy); and
 - Enhance the auditor's ability to design appropriate substantive procedures even when not relying on controls.
49. Auditors auditing entities of all sizes also noted that the:
- Requirement to obtain an understanding of internal control and control activities relevant to the audit can be difficult to apply in practice;
 - Requirement to evaluate the design and implementation of controls relevant to the audit²⁵ is not clear (i.e., regarding the objective of the requirement and the nature and extent of the work effort required in meeting the requirement) and how this can be effectively achieved for each of the components of internal control;
 - Guidance on identifying controls that are relevant to the audit is not clear, and in some cases this can result in controls testing that does not address the identified risks of material misstatement;
 - Requirements in ISA 315 (Revised) related to understanding internal control and control activities are excessive if, as is the case on many audits of SMEs, a wholly substantive approach to testing is adopted; and
 - Requirement in paragraph 18 of ISA 315 (Revised) for the auditor to obtain an understanding of the information system, including the related business processes, relevant to financial reporting, is by itself sufficient in order to identify the risks of material misstatement (i.e., there are no control activities relevant to the audit when the auditor does not plan to test and rely on controls).
50. As part of this project, the IAASB will therefore:
- (a) Clarify the concept of "internal control and control activities relevant to the audit" within ISA 315 (Revised) by explaining the purpose of obtaining the required understanding and that the expected extent of understanding of internal control and control activities is commensurate with the nature and size of the entity.
 - (b) Explore whether revisions are needed to ISA 315 (Revised) to address situations where substantive procedures alone are not enough to address the risks of material misstatement in light of increasing complexity in business processes and evolving technologies.

²⁵ ISA 315 (Revised), paragraph 13

- (c) Explore revisions to ISA 315 (Revised) to clarify the difference between testing of controls and assessing the design and implementation of controls, an area in the standard that is not well understood by all auditors.
 - (d) Explore whether updates to ISA 315 (Revised) are needed in response to updates to the COSO Internal Control–Integrated Framework (2013), which has been updated since the issuance of ISA 315 (Revised), while retaining a framework neutral approach in ISA 315 (Revised).
 - (e) Further explore the interactions of paragraphs 12 and 18 of ISA 315 (Revised). These are explained further in paragraphs 46 and 49 respectively of this Project Proposal.
51. Feedback from the ISA Implementation Monitoring Project indicates that, because IT risks are not emphasized sufficiently in ISA 315 (Revised), general IT controls may not be tested sufficiently when reliance is placed on IT-dependent control activities. Questions have also arisen in practice regarding the extent of the evaluation of the design and implementation of general IT control activities required when performing a wholly substantive audit. In addition, there could be better linkage between the relevance of general IT controls and control activities such that in an audit approach that may involve substantive testing only for some accounts as well as combination of substantive and controls testing for other accounts, the auditor can effectively understand how to identify both relevant control activities and general IT controls. The IAASB will explore revisions to ISA 315 (Revised) to clarify the importance of the auditor understanding the relationship between general IT control activities and audit evidence. For example, when documents or data are used for the audit (i.e., as audit evidence) that are produced by the entity's information systems, what approaches can the auditor take to rely on that information when the design and operating effectiveness of general IT control activities are assessed by the auditor, and when they are not.
52. The IAASB will also explore revisions to ISA 315 (Revised) that acknowledge the potential complexity of the entity's information system and the financial reporting process, and how the auditor would take such complexity into account in assessing the risks of material misstatement.
53. The IAASB, with input from the DAWG, will explore whether a distinction should be made regarding the extent of work effort expected to establish the accuracy and completeness of data used for risk assessment purposes compared to when data is used for substantive analytical procedures. In addition, the IAASB will explore the impact of using data analytics when gaining an understanding of internal control relevant to the audit.

Modernizing ISA 315 (Revised) for Developments in IT

54. Developments in technology, including the information systems used by entities to initiate, record, process and report transactions or other financial data, have been significant since ISA 315 (Revised) was issued in 2003. Respondents to the ISA Implementation Monitoring Project noted that ISA 315 (Revised) is not sufficiently reflective of the complexity of the information systems used by many entities. Outsourcing of various aspects of an entity's information system, such as in cloud computing arrangements, has recently become far more prevalent, and along with other developments in technology that affect the auditor's risk assessment (e.g., cyber risk in the context of the relevance to financial reporting) are requiring a renewed focus by auditors of the impact of technology on the audit of entities of all sizes.
55. The importance of the auditor having an appropriate understanding of the process and flow of information through the information system is increased as the information system used by the entity becomes more complex. The auditor's understanding of the flow of information including what could go wrong includes

factors related to the IT utilized as well as human factors. The IAASB intends to explore how the complexity of the entity's information system could be more of a consideration in the auditor's assessment of the risks of material misstatement.

Documentation of Risk Assessment Procedures

56. Respondents to the ISA Implementation Monitoring project indicated that more guidance is needed regarding the nature and extent of documentation for understanding the entity and its environment and internal control, in particular for the audits of SMEs. The IAASB will explore the extent of documentation of the risk assessment process and the level of granularity at which auditors are expected to document their risk assessments.

Definitions, Language and Structure of the Standard

57. There are a number of areas within ISA 315 (Revised) where the definitions and language used are not clear, resulting in confusion, misunderstanding and differing interpretations.
58. One example of this is in the area of controls. ISA 315 (Revised) makes references to the terms: internal control, relevant controls, identified controls, related controls, routine controls, appropriate controls, controls and control activities. These terms are used inconsistently within the standard, resulting in challenges for the auditor in interpreting the requirements of the standard, and also likely resulting in inefficiencies in documentation (as use of the different terms and phrases related to controls within ISA 315 (Revised) has been interpreted by some auditors to imply that there are separate documentation requirements for understanding each of the types of controls represented by each of the different terms, which is not the IAASB's understanding of the intent of the standard).
59. The IAASB will give further consideration to the definitions and use of these terms in ISA 315 (Revised), with the objective of removing the uncertainty for auditors in applying the standard.
60. Respondents to the ISA Implementation Monitoring project indicated that the organization of the standard is very complex, in particular in relation to internal control, such that the requirements and guidance are difficult to implement in a work flow or logical sequence of risk assessment procedures. The IAASB will explore different ways in which to better reflect the interdependence of the requirements in gaining an understanding of the entity and its environment.

Professional Skepticism

61. Adopting and applying a skeptical mindset is a personal and professional responsibility for every auditor. The application of professional skepticism is influenced by personal traits, including fortitude (i.e., the strength of mind that enables the auditor to deal with matters arising during the course of the audit with courage), and the auditor's competence (e.g., knowledge, skills and experience). Strong views have been expressed by the IAASB CAG and at IAASB roundtables about the importance of the auditor having a thorough understanding of the entity and its environment in order to facilitate a high-quality audit in which professional skepticism is appropriately applied.
62. The IAASB, in conjunction with the IAASB's Professional Skepticism Working Group (PSWG), will explore what should be done to re-emphasize the important role of professional skepticism in audits of financial statements, specifically related to risk assessment.

Connections to Other Standards

ISA 540

63. In December 2015, the IAASB approved the commencement of a standard-setting project to revise ISA 540. Matters to be considered by the ISA 540 Task Force that are likely to impact or be impacted by the ISA 315 (Revised) project include:
- The extent of understanding of the entity's governance processes, including monitoring of controls activities relevant to making accounting estimates, deemed necessary to inform the auditor's risk assessment.
 - Consideration of risks associated with the use of external data sources.
 - The link between the degree of estimation uncertainty and complexity of an accounting estimate, and whether that accounting estimate is a significant risk.
 - Considering how unintentional and intentional management bias is taken into account in the auditor's risk assessment procedures.
64. The IAASB will explore areas for improvement in the risk assessment process, relevant to risk assessments associated with fair value measurements and other estimates.

ISA 600

65. In the context of a group audit, issues have been identified related to the identification of significant risks. These include:
- Risks of material misstatement identified at the component level by component auditors are sometimes not appropriately considered at the group level (i.e., inappropriate consideration is given as to whether such risks are group-wide risks or whether such risks also exist at some or all of the other components).
 - In situations where group-wide significant risks have been identified that relate to all components, including non-significant components where no procedures are planned to be performed, it may be unclear as to where, or to which components, the work related to the significant risk is to be directed in order to appropriately respond to the risk.
66. In addition, other changes to ISA 315 (Revised) may also impact ISA 600, and the impact of changes made to significant risks, as well as any other changes, on ISA 600 will also be considered by the Group Audits Working Group.

ISA 220

67. Quality control at the engagement level is influenced by the entity and its environment. Paragraph 14 of ISA 315 (Revised) requires the engagement partner to be satisfied that the engagement team, and the auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:
- (a) Perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and
 - (b) Enable an auditor's report that is appropriate in the circumstances to be issued.

68. It is necessary, therefore, that the auditor has an appropriate understanding of the entity and its environment in order to meet the relevant requirements in ISA 220 related to the assignment of the engagement team and engagement performance (i.e., direction, supervision, performance, review and consultation).
69. The IAASB will explore whether a closer link between the auditor's understanding of the entity and its environment and the decisions regarding assignment of the engagement team and engagement performance should be made.

ISA 240 and ISA 330

70. It is expected that there will likely be consequential amendments to ISA 240 and ISA 330 arising from revisions to ISA 315 (Revised).
71. During the course of this project, it may be found that further consideration needs to be given to more substantive changes to one or both of these standards. A decision to move forward with more substantive revisions to ISA 240 or ISA 330, if and as necessary, will be made in consideration of a future IAASB Work Plan.

Consequential amendments to other standards

72. Revisions to ISA 315 (Revised) would potentially result in consequential amendments to standards other than those noted above.

Impact Analysis Considerations

73. The primary expected benefit of this project is an increase in audit quality through more robust requirements and appropriately detailed guidance to drive auditors to perform appropriate risk assessment procedures.
74. Regardless of whether the outcome of this project results in new or revised requirements and/or application material or other guidance, there will be implications for the audit, including in relation to both the cost and benefits of an enhanced risk assessment. It is anticipated that the impact on individual audits would vary depending on the size and complexity of the entity and other entity-specific factors; the IAASB will specifically consider the effect on audits of SMEs. The impact at the firm level will also vary depending on the methodologies currently in place, including areas where interpretations have been made that may differ from the final approach set out in a revised standard.
75. The aim of the project is to provide an additional focus on the expected work effort in relation to risk assessment and clarify what is expected to be documented in relation to this work effort. As such, the costs may increase for audits of certain entities. On the other hand, changes to the standard – in particular clarifying what drives risk – are expected to better facilitate the auditor's responses to those risk, which in turn should result in more efficient and effective audits that are appropriately focused on key areas.
76. In summary, establishing robust principles within the standard to strengthen the auditor's work effort with respect to risk assessment and enabling auditors to appropriately tailor their risk assessment based on the nature and size of the entity is expected to result in higher audit quality, which is in the public interest.

III. Implications for Any Specific Persons or Groups

77. The project has implications for all participants in the financial reporting supply chain, in particular for auditors who perform audits of financial statements. As the ISAs apply to all entities, the risk of unintended consequences to audits of smaller entities needs to be considered. In addition to other outreach,²⁶ IFAC's SMP Committee will be kept informed of developments to ensure appropriate input is received at key stages of the project.
78. The project also has implications for, and linkages with, other IAASB initiatives, including work on the topics of ISA 540, Professional Skepticism, Data Analytics, Quality Control, and Group Audits.

IV. Development Process, Project Timetable and Project Output

Development Process and Project Timetable

79. The project will be conducted in accordance with the Public Interest Activity Committees' Due Process and Working Procedures.²⁷
80. Subject to the IAASB's approval of the ISA 315 (Revised) project proposal, the project to revise ISA 315 (Revised) will commence immediately. The IAASB proposes the following preliminary timetable, noting that specific project milestones and outputs may change as the project develops.

Timing	Action
September 2016	Obtain the IAASB CAG's input on project proposal
	IAASB approval of project proposal and consideration of specific issues
December 2016	IAASB consideration of specific issues and proposals
March 2017 – December 2017	Obtain input from the IAASB CAG on the issues and proposals, including an exposure draft of revised ISA 315 (Revised) (including possible revisions or conforming amendments to other ISAs)
	IAASB deliberation of issues, proposals and a first and second read of the exposure draft. This includes consideration of whether additional pronouncements, such as IAPN or other non-authoritative guidance, are necessary to address specific issues
	Consideration of any relevant feedback from the IAASB's ISA 540 (Revised) exposure draft, expected to be released December 2016
	Dialogue with stakeholders on key issues and proposals
March 2018	IAASB approval of exposure draft, with a 120-day comment period, including possible conforming amendments to other ISAs
2018	Development of possible IAPN(s) or other non-authoritative guidance

²⁶ The IAASB will continue its dialogue with stakeholders such as the IFIAR SCWG, IOSCO, European Audit Inspection Group, the Forum of Firms, Global Public Policy Committee.

²⁷ https://www.ifac.org/system/files/uploads/PIAC-Due_Process_and_Working_Procedures.pdf

	Obtain IAASB CAG input on consideration of the responses to the exposure draft and proposed changes to ISA 315 (Revised 2018) as a result of those responses
	IAASB deliberation of responses to the exposure draft and resulting proposed changes to ISA 315 (Revised 2018)
Q1 2019	IAASB approval of ISA 315 (Revised 2018) and publication of possible IAPN or other non-authoritative guidance

Project Output

81. The expected output of the project is a revised ISA 315 (Revised), with revisions, or conforming amendments, to certain ISAs as appropriate. The ISA 315 (Revised) Task Force will, throughout the revision of the standard, consider and advise the IAASB as to the need for, and potential timing of, development of other non-authoritative guidance, in the form of an IAPN, Staff publication, project update or other material.

V. Resources Required

82. A project Task Force will be responsible for the project to revise ISA 315 (Revised), and will be comprised of IAASB members, technical advisors, and external experts, as appropriate, with diverse backgrounds. IAASB Staff will provide support to the ISA 315 (Revised) Task Force.