

ISA 315 (Revised)¹—Issues and Recommendations

Objective of the Agenda Item

The objective of this agenda item is to obtain CAG Representatives and Observers' views on the working group's recommendations to address selected issues.

I. Background and Key Concepts in ISA 315 (Revised)

1. As noted in the project proposal (**Agenda Item 3-A**), the ISA 315 (Revised) Working Group (the WG) has prioritized aspects of possible revisions to ISA 315 (Revised) to be able to respond to concerns relating to ISA 540 as work on developing changes to that standard progresses. Therefore the WG seeks the CAG Representatives and Observers' input on the following three matters with respect to the ISA 315 (Revised) project:
 - The components of internal control relevant to the audit (**Section II**);
 - Significant risks – assessment of the risk of material misstatement, specifically determining those risks of material misstatement that are a significant risk (**Section III**); and
 - Spectrum of risk – a “spectrum” of risks of material misstatement culminating in those that are determined to be significant risks (**Section IV**)

The WG explored each of these issues in the context of the existing audit risk model (“the model”), specifically, the interaction of inherent risk and control risk with detection risk. The remainder of this Section provides background on the relationship of the issues identified to the model, as well as background on the model itself.

Audit Risk

2. “Audit risk” is defined in the glossary of terms as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. “Audit risk” is a function of the “risks of material misstatement” and “detection risk.”
3. The “risk of material misstatement” is defined in the glossary of terms as the risk that the financial statements are materially misstated prior to audit. This consists of two components at the assertion level; “inherent risk” and “control risk” which are discussed in paragraphs 5-6 and 9-10 below, respectively. As a result, the “risk of material misstatement” is a function of “inherent risk” and “control risk.” Across the relevant assertions, the relative significance of the assessed “risks of material misstatement” will vary, which requires the auditor to vary the nature, timing and extent of their procedures in response to the assessed “risks of material misstatement.”
4. ISA 315 (Revised) does not include any specific mention of “inherent risk” or “control risk”, but only to the risks of material misstatement. This is because paragraph A40 of ISA 200² explains that the ISAs do not

¹ International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

² ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

ordinarily refer to inherent risk and control risk separately, but the auditor may nevertheless make separate or combined assessments of “inherent risk” and “control risk”. In light of the ability of the auditor to make separate assessments of “inherent risk” and “control risk”, the WG believes it is appropriate to explore certain issues in the context of the separate risk assessments in order to provide further clarity on the extent to which required risk assessment procedures inform the auditor’s inherent risk assessment or the auditor’s control risk assessment. As a result, the WG’s exploration of the issues presented herein includes consideration in context of these separate risk assessments when relevant.

Inherent Risk

5. “Inherent risk” is defined in the glossary of terms 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. When the term “controls” is used it refers to any aspects of one or more of the components of internal control.³
6. This definition of “inherent risk” is often applied literally in practice, such that auditors disregard controls when making an assessment of “inherent risk”. Auditors find it challenging to assess “inherent risk” using the knowledge they have obtained through understanding the entity and its environment while not also considering their understanding of an entity’s internal control. However, there are others that do not read this as a requirement to disregard the information that they have about controls, but instead read the definition as simply identifying “inherent risk” as the ‘gross’ risk of material misstatement (i.e., before mitigation by controls). This issue is further explored in **Section II**.

Significant Risk

7. Paragraph 4(e) of ISA 315 (Revised) defines “significant risk” as an identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration. In determining which, if any, of the identified and assessed risks of material misstatement are significant risks, the auditor is required to exclude the effects of identified controls related to the risks.⁴ “Significant risk” is therefore interpreted to be a subset of higher inherent risk, although this is not explicitly stated in the definition or any requirements or guidance within ISA 315 (Revised) related to “significant risk”. Furthermore, in practice many auditors have noted that they find it challenging to determine which risks of material misstatement are “significant risks”, because the definition of a “significant risk” focuses on the work effort required by the auditor rather than on the nature, impact or probability of the risk.
8. The findings of the ISA Post-Implementation Monitoring project,⁵ published in July 2013, comprised key and important themes⁶ specifically related to ISA 315 (Revised) including the requirements and related

³ ISA 315 (Revised), paragraph 4(c)

⁴ ISA 315 (Revised), paragraph 27

⁵ The IAASB’s [ISA Implementation Monitoring](#) project was a post-implementation review of the ISAs clarified and revised in the IAASB’s Clarity project, and was completed in July 2013. The primary objective of the post-implementation review was to determine what, if any, changes are needed in order to increase the consistency of practitioners’ understanding of the ISAs; and, whether the IAASB achieved its goals in revising them.

⁶ Issues identified were classified as “key” when there was a body of evidence to suggest that the ISA was not being consistently understood and applied in a manner that achieved the IAASB’s goals in revising it. In addition, changes to that ISA would also likely have the greatest potential for improving audit quality. Themes were classified as “important” when there was some evidence that the ISA was not being consistently understood and applied in a manner that achieved the IAASB’s goals in revising it.

application material in ISA 315 (Revised). One of the ‘key’ themes identified related to the significant risks that are being identified (e.g., given similar engagement facts and circumstances identification of significant risks by different people may result in different risks (i.e., by nature and number) being identified). Respondents to the ISA Post-Implementation Monitoring project noted that this has a consequential effect on the work effort to respond to these risks. **Section III** includes the WG’s exploration of the clarification of the concept and definition of significant risk.

Control Risk

9. “Control risk” is defined in the glossary of terms as the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control. Paragraph 7(ii) of ISA 330⁷ explains that when the assessment of a risk of material misstatement takes into account relevant controls (i.e., “control risk” is assessed at less than the maximum and the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures), the auditor is required to obtain audit evidence to determine whether the controls are operating effectively. Therefore, auditors can only fully conclude on the assessed level of “control risk” (i.e., validate the auditor’s control risk assessment) by testing the operating effectiveness of controls (in addition to the auditor’s evaluation of the design and implementation of the controls as part of the auditor’s risk assessment).
10. ISA 315 (Revised) states⁸ 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, 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. The WG discussions included how the understanding of the entity’s internal control supports the auditor’s assessment of the risk of material misstatement (see **Section II** paragraphs 18-22).

Identification of internal control and control activities relevant to the audit

11. Respondents to the ISA Post-Implementation Monitoring project noted that the requirements to obtain an understanding of internal control⁹ and control activities¹⁰ ‘relevant to the audit’ can be difficult to apply in practice. A number of respondents also suggested that the requirements relating to understanding controls in ISA 315 (Revised) are excessive when substantive procedures alone are performed to respond to the risks of material misstatement, as is the case on many smaller audits.
12. When obtaining an understanding of the entity and its environment including the entity’s internal control, paragraph 12 of ISA 315 (Revised) requires the auditor to obtain an understanding of internal control relevant to the audit and further explains that it is a matter of professional judgment whether a control is relevant to the audit. The WG has considered the purpose of understanding internal control, including

⁷ ISA 330, *The Auditors Responses to Assessed Risks*

⁸ ISA 315 (Revised), paragraph 3

⁹ Paragraph 12 of ISA 315 (Revised) requires the auditor to obtain an understanding of internal control relevant to the audit.

¹⁰ Paragraph 20 of ISA 315 (Revised) requires the auditor to obtain an understanding of control activities relevant to the audit...in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks.

whether each of the five components of internal control may (or may not) be relevant to an audit, and this is discussed further below in **Section II**.

Detection Risk

13. “Detection risk” is defined in the glossary of terms as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. If the auditor has not appropriately assessed “inherent risk” and “control risk” they may not appropriately address “detection risk” through the design of appropriate audit procedures. The objective of ISA 330 is for the auditor to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks (i.e., ISA 330 covers the auditor addressing detection risk). The WG has focused on the issues identified primarily in the context of ISA 315 (Revised) but has given some consideration to the effects on the auditor’s response for certain issues recognizing that revision of ISA 315 (Revised) is likely to result in consequential amendments to ISA 330. The views of the WG on the implications for ISA 330 are included in the discussion of the issues in **Section III** below.

II. The Components of Internal Control Relevant to the Audit

Issues

14. ISA 315 (Revised) identifies five components of internal control as follows:¹¹
 - a. The control environment;
 - b. The entity’s risk assessment process;
 - c. The information system, including the related business processes, relevant to financial reporting (referred to herein as information system relevant to financial reporting), and communication;
 - d. Control activities relevant to the audit; and
 - e. Monitoring of controls.
15. In addition to requirements addressing the extent to which the auditor should obtain an understanding of each component of internal control in paragraphs 14–24, extant ISA 315 (Revised) includes an overarching requirement in paragraph 12 for the auditor to understand “internal control relevant to the audit.”
16. Several of the matters noted in the ISA Post-Implementation Monitoring project related to challenges experienced by auditors, including those who perform audits of small- and medium-entities (SMEs), in

¹¹ ISA 315 (Revised), paragraphs 14–24 and A58. The WG has not yet considered the full implications of the Committee of Sponsoring Organizations of the Treadway Commission (COSO)—Internal Control—Integrated Framework (2013) on the components of internal control as described in ISA 315 (Revised) and will do so as the project progresses. The WG’s exploration of issues and recommendations related to the understanding of internal control are in the context of the components of internal control as described in extant ISA 315 (Revised).

particular relating to the extent of understanding of internal control that is necessary. 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;
 - 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 relevant to financial reporting, including the related business processes, is by itself sufficient to enable the auditor 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).
17. Often, SMEs engage in relatively simple business transactions, which mean that the audit of an SME under the ISAs will generally be less complex. In the course of outreach performed to date, views have been expressed by some auditors of SMEs that, where the entity and its systems and processes are less complex, the auditor may prefer to make a strategic decision not to obtain any understanding of the entity's internal control and not to rely on the operating effectiveness of controls from any component of internal control in determining their substantive testing but rather to deem control risk to be at the maximum level for this purpose. Some auditors believe that this approach is consistent with the requirements of ISA 315 (Revised) because they believe that paragraph 12 of the standard can be interpreted as an overarching determination of whether internal control is at all relevant to the audit. They further believe that, if they conclude that it is not at all relevant to the audit (which they believe is a reasonable conclusion when they have made such a strategic decision), they do not then need to meet the requirements of paragraphs 14–24 of ISA 315 (Revised).

WG Discussion – The Purpose of the Auditor's Understanding of Internal Control in the Context of the Model

18. Paragraph 48 of **Agenda Item 3-A** noted 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 of material misstatement 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.

Paragraph A49 of ISA 315 (Revised) addresses the purpose of understanding internal control. The placement of the stated purpose of the auditor obtaining an understanding of internal control may need to be more prominently placed in the requirements and further clarification of the purpose in the ISAs would likely be helpful.

19. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.¹² The auditor's understanding of internal control, together with the auditor's understanding of the entity and its environment, provide a basis for the auditor's assessment of risks of material misstatement at the financial statement and assertion level. ISA 315 (Revised) does not specify which aspect of the risk of material misstatement (i.e., inherent risk or control risk) the understanding of internal control impacts. The WG is of the view that is useful to explore the purpose of the understanding of internal control in the context of the auditor's inherent risk assessment, particularly in light of the fact that inherent risk is defined to be considered before any related controls.
20. In the view of the WG, the purpose of obtaining an understanding of internal control goes beyond informing the auditor's control risk assessment; it also has a significant role in informing the auditor's inherent risk assessment. This view is similar to the view of those that do not read the definition of inherent risk as requiring the auditor to disregard the information that the auditor has about controls but rather read the definition as simply identifying inherent risk as the 'gross' risk of material misstatement (i.e., before mitigation by controls) (see paragraph 6 above). The control risk assessment is therefore interpreted to be the assessment of the extent to which the controls mitigate the inherent risk, which is supported by the fact that the auditor cannot conclude on control risk unless the auditor has obtained audit evidence to determine whether controls are operating effectively (see paragraph 9 above).
21. Examples of aspects of the auditor's understanding of internal control that the WG believes affect the auditor's inherent risk assessments include:
 - The evaluation, as part of understanding the control environment, of whether management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior.
 - The understanding of how management identifies business risks and estimates the significance of those risks as part of the understanding of the entity's risk assessment process.
 - The understanding of the financial reporting process and how the information system relevant to financial reporting captures events, conditions and transactions.
22. The WG has the view that clarification of the purpose of the auditor gaining an understanding of internal control by linking it to the assessment of inherent risk could address some of the challenges of assessing inherent risk noted in practice, and further clarify the linkage between obtaining an understanding of internal control and the assessment of the risks of material misstatement. The WG is of the view this clarification would result in greater consistency in inherent risk assessments and therefore the assessment of the risks of material misstatement, which is likely to improve audit quality. The consequence of making this clarification is that the definition of inherent risk may also need to be revisited (in line with paragraphs 57–60 of **Agenda Item 3-A**).

Matters for CAG Representatives and Observers' Consideration

1. Do CAG Representatives and Observers' agree that the purpose of understanding internal control should be linked to the auditor's assessment of inherent risk by clarifying how the concepts are related?

¹² ISA 315 (Revised), paragraph A49

2. Are there additional factors (see paragraph 18 above) to add to the purpose of the auditor obtaining an understanding of internal control?

WG Discussion – Internal Control Relevant to the Audit

23. Paragraph 12 of ISA 315 (Revised) “requires the auditor to obtain an understanding of internal control relevant to the audit,” with paragraphs 14–24 of ISA 315 (Revised) being the requirements the auditor needs to comply with in order to obtain that understanding for the respective component of internal control. However, some have interpreted the requirement in paragraph 12 of ISA 315 (Revised) to mean that if a fully substantive approach to an audit will be undertaken then obtaining an understanding of internal control is not relevant and therefore none of the requirements in paragraphs 14–24 of ISA 315 (Revised) need to be complied with. In addition, there have been questions whether the requirement for the auditor to obtain an understanding of internal control needs to include all five components in every audit, or whether, in some cases, the auditor needs to obtain an understanding of only some of the components of internal control.
24. The WG is of the view, given the differing views about the auditor’s understanding of internal control “relevant to the audit” heard in outreach, that clarification in ISA 315 (Revised) is needed and should be further explored.
25. The WG considered the appropriate nature and extent of the understanding of each component of internal control in ISA 315 (Revised), including the circumstances under which components or aspects of components should be deemed “relevant to the audit,” or may be deemed to be not relevant to the audit.

WG Views – Internal Control Relevant to the Audit

26. The WG is of the view that the intention behind paragraph 12 of ISA 315 (Revised) is for the auditor to consider all five components of internal control (if they exist) and to obtain an understanding of each of them, to the extent that each of them is “relevant to the audit.”
27. The WG’s discussions explored what is meant by “relevant to the audit”, as that is an aspect of the requirement in paragraph 12 of ISA 315 (Revised) that is not clearly understood and is interpreted differently (see paragraphs 23 and 24 above). As summarized in Table 1, the WG formed a view on the relevance to the audit of the control environment, the entity’s risk assessment process and information system relevant to financial reporting and communication components. For the control activities and the monitoring of controls components, the WG explored their relevance to the audit, particularly as it relates to audits of SMEs or audits where the auditor does not intend to test the operating effectiveness of controls, and believes there may be opportunities for clarifying the relevance to the audit for these two components. The WG is seeking input from the Board to inform how the WG proceeds (see Matters for CAG Representative and Observers’ Consideration that follow directly after paragraph 34 below).

Table 1

Component of Internal Control	Views identified related to understanding the various components of internal controls relevant to the audit
The control environment	ISA 315 (Revised) requires the auditor to obtain an understanding of the control environment. The WG is of the view that this component, consistent with extant ISA 315 (Revised), should always be considered relevant to the audit primarily

(ISA 315 (Revised) paragraph 14)	because the control environment component provides a foundation for the other components of internal control. Although the control environment in itself does not prevent or detect material misstatement, it can have a pervasive effect on the auditor's assessment of the risks of material misstatement.
The entity's risk assessment process (ISA 315 (Revised) paragraphs 15–17)	<p>The requirement to understand the entity's risk assessment process in paragraph 16 of ISA 315 (Revised) is conditional on the fact that such a risk assessment process exists. The entity's risk assessment process forms the basis for how management determines the risks to be managed.</p> <p>When such a risk assessment process exists, and is judged by the auditor to be appropriate to the circumstances, including the nature, size and complexity of the entity, paragraph A87 of ISA 315 (Revised) further explains that this component is relevant to the audit because it assists the auditor in identifying risks of material misstatement.</p> <p>The WG is of the view that when such a risk assessment process exists, it is appropriate to require the auditor to understand it for this reason.</p>
The information system relevant to financial reporting and communication (ISA 315 (Revised) paragraphs 18–19)	The WG is of the view that consistent with the current requirements in ISA 315 (Revised) this component should always be considered relevant to the audit primarily because it provides the auditor with an understanding of the flow of information, which is necessary to identify at which points in the flow of information a misstatements could occur—that is, this understanding identifies “what could go wrong.” The flow of information will be different for each entity (i.e., based on people, process and technology) and therefore will result in different risks being identified.
Control activities (ISA 315 (Revised) paragraphs 20–21)	<p>The auditor is required to obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks.¹³</p> <p>Control activities that are relevant to the audit are those that are required to be treated as relevant to the audit and those control activities considered to be relevant in the judgment of the auditor. The auditor's judgment of relevance is influenced by the risk identified that may give rise to a material misstatement, and whether the auditor is likely to test the operating effectiveness of the control. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.¹⁴</p> <p>The WG explored the extent to which understanding control activities relevant to the audit should be required in all audits, or only in some circumstances. See further discussion in the ‘control activities’ section below.</p>

¹³ ISA 315 (Revised), paragraph 20

¹⁴ ISA 315 (Revised), paragraphs A97–A100

<p>Monitoring of controls (ISA 315 (Revised) paragraphs 22–24)</p>	<p>ISA 315 (Revised) requires the auditor to obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting.¹⁵ Monitoring of controls is viewed to be “controls over controls” by the WG.</p> <p>The WG is of the view that the monitoring of controls component is always relevant (to the extent set out in ISA 315 (Revised)) if the auditor intends to test the operating effectiveness of controls regardless of the extent to which such testing is planned to be performed (i.e., only to address the risk of material misstatement related to certain assertions or to address the risk of material misstatement related to the majority of assertions). This is because when the auditor intends to rely on the operating effectiveness of a control, understanding the “controls over controls” is important to determining whether the entity has processes in place that address the continued effectiveness over time of the controls identified for testing.</p> <p>Furthermore, even when not intending to rely on the operating effectiveness of controls, the WG believes that the requirement in ISA 315 (Revised), paragraph 23 to understand the nature of the internal audit function, its organizational status and the activities performed, is always relevant to the audit when an internal audit department exists.</p> <p>When not intending to rely on the effectiveness of controls, the WG debated whether it would be necessary for the auditor to obtain an understanding of the entity’s major activities to monitor internal control over financial reporting.</p> <p>The WG acknowledges that although an understanding of the monitoring of controls can be useful in informing the auditor’s inherent risk assessment, the extent of the usefulness of obtaining that understanding may be less in non-complex environments or when the auditor is not planning to test the operating effectiveness of controls. Understanding the monitoring of controls component is likely more useful when the entity has a robust process for monitoring of controls. The WG seeks further input from the Board on the scalability of this component.</p>
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WG Views – Control Activities

28. It was noted in Table 1 that the WG has explored the extent to which an understanding of control activities is required on every audit. ISA 315 (Revised) states that “control activities that are relevant to the audit are:
- (a) Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30 of ISA 315 (Revised), respectively; or
 - (b) Those that are considered to be relevant in the judgment of the auditor.”¹⁶

¹⁵ ISA 315 (Revised), paragraph 22

¹⁶ ISA 315 (Revised), paragraph A97

29. Gaining an understanding of the control activities relevant to the audit requires the auditor to apply their judgment as to what control activities are necessary to understand in order to assess the risks of material misstatement at the assertion level, and design further audit procedures responsive to those assessed risks. Differing views, including those expressed through outreach activities, have been explored by the WG regarding the circumstances under which the requirement for the auditor to obtain an understanding of control activities relevant to the audit, beyond those circumstances required by ISA 315 (Revised) as noted in paragraph 28(a) above, applies.
30. One view that has been expressed is that in the auditor's professional judgment all control activities relevant to financial reporting should be understood. The basis for this view is that the auditor needs to understand all of the control activities relevant to financial reporting to inform the auditor's assessment of inherent risk and control risk, and to design appropriate procedures (whether tests of control or substantive procedures) to respond to them. Obtaining that understanding allows the auditor to assess the appropriateness of control activities in relation to the circumstances, including the nature, size and complexity of the entity and provide the entity with recommendations for improvement, if any.
31. A second view expressed is that the only control activities that are relevant to the audit (and which the auditor would be required to obtain an understanding of) are those control activities that:
- The ISAs specifically require the auditor to obtain an understanding of (see paragraph 28 above); and
 - The auditor intends to test the operating effectiveness of in response to the assessed risks of material misstatement.

If the auditor determined there were no control activities appropriate to test the operating effectiveness of, then the auditor would be required to obtain an understanding only of those control activities required by the ISAs.

32. A third view expressed is that the exercise of the auditor's professional judgment in determining control activities relevant to the audit should result in the need for the auditor to obtain an understanding of some specific control activities relevant to the audit (beyond those circumstances noted in paragraph 31 above), but not necessarily be required to obtain an understanding of all control activities relevant to financial reporting. Application material in ISA 315 (Revised) does contain some limited guidance for the auditor to consider circumstances where the "risks of material misstatement are likely to be higher"¹⁷ and that "the auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities."¹⁸ However, there is a lack of clarity in ISA 315 (Revised) regarding the criteria that the auditor might consider in the identification of specific control activities relevant to the audit.

Request for CAG Representatives and Observers' Input

33. As noted, the WG has reached a view that the control environment and information system components are always relevant to the audit, while the risk assessment process component is relevant when it exists. The WG seeks further views from the Board whether it agrees with this view, or whether there are further

¹⁷ ISA 315 (Revised), paragraph A99

¹⁸ ISA 315 (Revised), paragraph A100

scalability possibilities that the WG should explore in the context of these components. Also, as noted, the WG has not yet reached a view on the relevance of the control activities and monitoring of controls components and is looking for CAG Representatives and Observers' views to be able to move forward with clarifications. How this is clarified may also be dependent on the views on matters addressed in **Section III** of this paper related to significant risks.

34. The WG is of the view that clarifying these matters would address the diversity in practice in this area.

Matters for CAG Representatives and Observers' Consideration

3. Do CAG Representatives and Observers agree with the WG's views that the auditor needs to consider all five components of internal control (if they exist) and obtain an understanding of each of them, to the extent each of them is "relevant to the audit"?
4. Do CAG Representatives and Observers agree with the WG's views in Table 1 regarding the extent to which the control environment, risk assessment process and information system relevant to financial reporting and communication components are relevant to the audit?
5. The WG seeks input from CAG Representatives and Observers on how the relevance to the audit may be scalable for the control activities and monitoring of control components, in light of the WG's exploration of these two components noted in Table 1 and the 'control activities' section (paragraphs 28-32).
6. Are there any other matters the WG should consider in moving forward with clarifying this area in ISA 315 (Revised)?

Items Identified for Further Consideration by the WG

35. In relation to paragraphs 12 to 24 of ISA 315 (Revised) and the related guidance, there are a number matters which the WG is still to further consider for presentation to the CAG Representatives and Observers for its views. These include:
- Professional skepticism overlay – the WG is conscious that at this stage it has not applied the lens whereby consideration is given to additional ways of enhancing the application of professional skepticism in these requirements and application guidance. The WG will work closely with the Professional Skepticism Working Group to ensure this is appropriately considered.
 - The phrase "relevant to the audit" is used in several places in ISA 315 (Revised) and the WG would like to discuss further if there are ways to enhance either the requirements or the application material to make it clearer as to what is intended by the use of this phrase.
 - Development of application material to explain why the control environment and the information system relevant to financial reporting components of internal control are always considered "relevant to the audit."
 - Development of application material to explain the extent to which the other three components of internal control (risk assessment, control activities and monitoring of controls) may or may not be considered to be "relevant to the audit" and why.

- Specific exploration of paragraph 13 of ISA 315 (Revised), which includes an overarching requirement for the auditor to evaluate the design of the controls relevant to the audit and determine whether they have been implemented, in context of each component of internal control.
- Regarding the five components of internal control, the WG understands that this five component classification was introduced in 2003 and was sourced from the COSO Internal Control–Integrated Framework (1992) that was in existence at that time. The COSO Internal Control–Integrated Framework (1992) was revised in 2013. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than these five components, provided all the components described in ISA 315 (Revised) are addressed. The WG has not considered the full implications of the new COSO on the components of internal control as described in ISA 315 (Revised) and will do so as the project progresses.

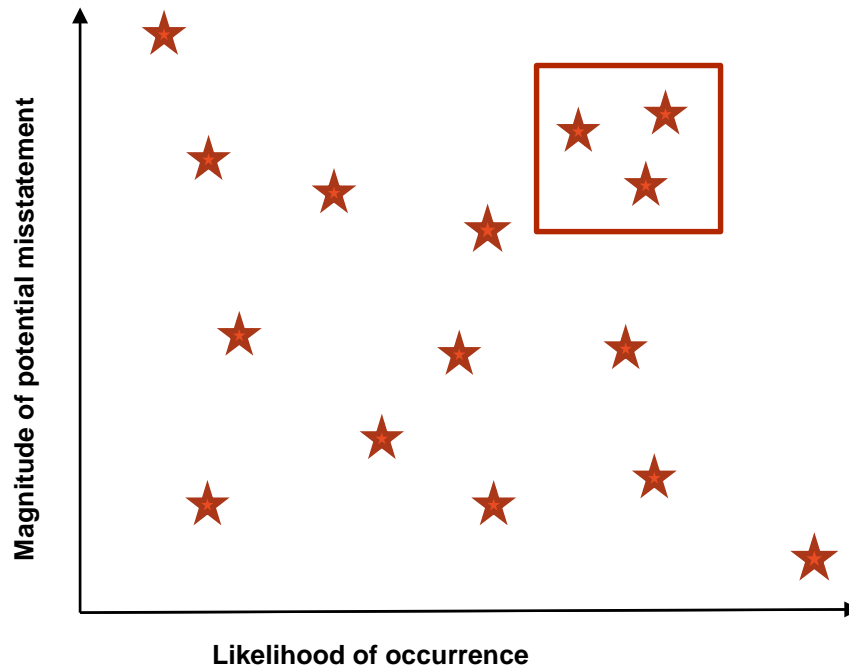
IV. Significant risk

Issues

36. As part of the risk assessment, the auditor is required to determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor is required to exclude the effects of identified controls related to the risk.¹⁹ As a result, significant risks are a subset of inherent risks.
37. Significant risk is defined as "an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration."²⁰ Neither the definition of significant risk nor the requirements for the determination of significant risks include definitive criteria for identifying significant risks. The auditor's determination of significant risks is heavily reliant on the auditor's professional judgment as to which inherent risks present the greatest risk of material misstatement and therefore require special audit consideration. In determining which inherent risks rise to the level of significant risks, some factors to consider are provided in paragraph 28 of ISA 315 (Revised). Paragraphs A132–A134 further explain that significant risks often relate to significant non-routine transactions or judgmental matters and also include examples of non-routine or judgmental matters. It can be deduced that a greater response is required when there is a greater risk of material misstatement and therefore may be a significant risk.
38. Based on the requirements and guidance in ISA 315 (Revised) addressing significant risks, the purpose of identifying significant risks seems to have been for the auditor to appropriately focus on the highest inherent risks.
39. In determining significant risks, in practice, some auditors consider the likelihood and potential magnitude (concepts that are included in various ISAs, but not specifically within ISA 315 (Revised)) of the inherent risk to assist in narrowing the population of inherent risks to those that represent greater risk of material misstatement. The following figure is a depiction of how inherent risk might be considered in this manner.

¹⁹ ISA 315 (Revised), paragraph 27

²⁰ ISA 315 (Revised), paragraph 4(e)



40. However, even when such a method is used, significant auditor judgment is still required to determine which of the inherent risks identified have both a higher likelihood of occurrence and a higher magnitude of potential misstatement in the financial statements.
41. As noted in **Agenda Item 3-A**, there is particular concern from some stakeholders that there is too much subjectivity in the determination of what is a significant risk in practice, with a consequential effect on the consistency and extent of work effort to respond to the assessed risks of material misstatement. Feedback from a variety of stakeholders further indicates 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, and this circular definition may be contributing to the inconsistent identification of significant risks in practice.
42. It has also been noted that auditors sometimes have difficulties in understanding what is meant by the term 'special audit consideration' in the definition of a significant risk, beyond performing tests of controls and substantive procedures that are responsive to a particular risk. The WG has the view that the definition of significant risk has resulted in unintended consequences in practice. Specifically, if an auditor does not believe that a risk requires any 'special audit consideration' in the sense of requiring the auditor to do something out of the ordinary to respond to it, the risk may not be considered a significant risk in circumstances when it would be appropriate to do so.
43. Further, the difficulty auditors have reported in assessing inherent risks without consideration of controls (as discussed in paragraphs 5–6 above) may also be contributing to challenges in the auditor's determination of significant risks. For example, some auditors may determine that the risks of material misstatement are high for many assertions, before taking account of the effects of controls, leading to a large population of high inherent risks, the relative significance of which may be difficult to assess in determining whether they are significant risks.

WG Discussion

44. The WG discussions to date have explored:
- The purpose of identifying significant risks, and whether the concept of significant risk should be retained in ISA 315 (Revised); and
 - If retained, how the concept might be improved to achieve the purpose intended, including how the definition of significant risk can be clarified to remove misunderstanding and differing interpretations as discussed in paragraphs 57–60 of **Agenda Item 3-A**.
45. The diagram in paragraph 39 above is useful in presenting possible combinations of different natures and extents of inherent risks in terms of their likelihood and magnitude. The WG is of the view that this relative inherent risk should be considered for each risk (not those only in the upper right corner) in order for the auditor to develop an appropriate proportionate response to the risk. One possible way to do so would be through emphasizing in ISA 315 (Revised) the need to recognize and respond to a “spectrum of risk” that culminates in significant risks, as explained in **Section IV**. Those aspects of the audit that fall on the upper end of a spectrum of risk (i.e., the greater the combined assessment of the magnitude and likelihood of inherent risk) should receive the greatest focus by the auditor because these areas may present the need for the most persuasive audit evidence and may, in some cases, pose the greatest challenges in obtaining sufficient appropriate audit evidence.
46. The WG also discussed whether the concept of significant risk should be retained in ISA 315 (Revised).

WG Views

47. The WG is of the view that the concept of significant risk should be retained to facilitate the auditor appropriately addressing the highest assessed inherent risks. This WG view is based primarily on the fact that those inherent risks that pose a serious threat of risk of material misstatement should be separately identified, with particular attention drawn by the auditor, and other participants in the financial reporting supply chain, to these risks. However, the significant risk concept should be improved to drive consistent and complete identification of significant risks by auditors.
48. The WG therefore suggests that the following improvements to the concept of significant risk are necessary:
- Revising the definition of significant risk to focus on the nature of the risk rather than the nature of the response, while better explaining how the response would be expected to be different (with implications for possible consequential amendments to ISA 330); and
 - Development of supporting criteria for a more structured identification of significant risk (beyond the factors to consider included in paragraph 28 of ISA 315 (Revised)).
49. The WG agreed that the auditor's consideration of the likelihood and magnitude of the assessed inherent risks may be an appropriate starting point for the auditor to narrow the population of inherent risks to those that present a greater risk of misstatement. To determine these inherent risks that present a greater risk of misstatement, the WG has the view that the criteria to be applied by the auditor, in assessing the likelihood and magnitude of the identified inherent risks, should focus on the nature of the risks.

50. The WG identified the following factors related to the nature of inherent risks, including significant risks, as particularly relevant to consider in evaluating the relative likelihood and magnitude of the related risk:
- (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 financial reporting framework (FRF). For example, complexity may necessitate the use of a complex model to determine a fair value, or may result from 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. Where the matter is more subjective, the judgment may be more susceptible to management bias.
 - (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.
51. When considering these factors together, the WG recognized that these factors have a commonality – risks that meet this criteria are also typically more difficult for management to control. The WG further considered the other factors listed in paragraph 28 of ISA 315 (Revised), such as significant or unusual transactions and risks of fraud, and concluded that risks related to these matters also are likely to be considered difficult for management to control.
52. Consequently, the WG proposes that a specific “filter” that the auditor may be able to apply, in determining significant risks, to the population of higher inherent risks as part of the auditor’s inherent risk assessment could be whether those higher inherent risks are difficult for management to control. For clarification, the filter of difficult for management to control would be applied to those inherent risks assessed by the auditor to be higher inherent risks only. Further, because of the difficulty for management to control such matters, the WG has the view that the auditor should obtain an understanding of the entity’s controls, including control activities, relevant to that risk, as is currently required by paragraph 29 of ISA 315 (Revised).
53. Acknowledging that understanding control activities related to significant risks is already required by extant ISA 315 (Revised), the WG views such understanding as critical to the auditor’s ability to design and implement an appropriate response to such risks, because it is likely that the auditor:
- May need to place less reliance (or in some circumstances not be able to rely) on tests of controls related to the risk, as such controls are inherently difficult for management to design and implement or may not be implemented; and
 - Must perform substantive procedures beyond substantive analytical procedures to include tests of details and other procedures that are directly responsive to the risk in order to obtain more persuasive audit evidence.

54. In **Section II**, the WG sets forth the proposal that the auditor's understanding of internal control informs the auditor's inherent risk assessment (see paragraphs 19–22 above). If the auditor's obtaining an understanding of internal control is incorporated into the concept of inherent risk, the WG has the view that this would:

- Provide an improved basis for the concept of significant risk to continue to be a sub-set of the highest inherent risks of material misstatement identified, because the auditor's understanding of internal control would assist in determining those risks that are difficult for management to control; and
- Result in the need for the concept of significant risk to be supplemented with guidance on circumstances where the above factors (paragraph 50 above) give rise to difficulty for the entity to control the higher inherent risks.

Matters for CAG Representatives and Observers' Consideration

7. Do CAG Representatives and Observers agree that the concept of significant risk should be retained? If yes, CAG Representatives and Observers are asked for their views on the WG's proposals regarding improvements to the concept of significant risks as set out in paragraph 48 above. If no, are there other approaches to improving the concept of significant risks that the WG should explore?
8. The CAG Representatives and Observers are asked for their views on:
 - (a) The WG's proposal that a specific "filter" be applied to the population of identified higher inherent risks; and
 - (b) Whether that filter should be based on risks that are difficult for management to control when determining significant risks? If not, is there another mechanism that should be considered for determining significant risks?

55. The WG also identified that the current determination of significant risks without consideration of controls may be inappropriately limiting the identification of significant risks by the auditor. Specifically, any risks of material misstatement that management fails to control, or has chosen not to control, could result in similar consequences to the audit strategy as outlined in paragraph 53 above, and therefore could be of the nature of significant risks in the WG's view. For example, the inherent risks related to payroll classes of transactions and related accounts may be typically assessed as lower due to their routine nature and the need for little subjectivity. However, if the auditor identifies that management has not appropriately implemented controls over payroll, this would likely significantly increase the auditor's assessment of the risk of material misstatement and consequential response, and therefore could be of the nature of a significant risk.
56. Given that the ISA 315 (Revised) definition refers to significant risks in the context of the "identified and assessed risks of material misstatement," this may be misinterpreted by stakeholders as already including the auditor's consideration of controls (and not only the auditor's inherent risk assessment).
57. The WG has explored whether, in addition to the "filter" discussed in paragraphs 51–53 above, a second "filter" or criteria should be included for the determination of significant risks related to risks that management fails to control, or has chosen not to control.

58. Following from the discussion in **Section II**, although it is proposed that the inherent risk assessment now include consideration of the auditor's understanding of internal control, this understanding may not always be sufficient for the auditor to identify those inherent risks that management fails to control, or has chosen not to control. Specifically, the ability to identify risks that management has failed to control or has chosen not to control may include the need for the auditor to also consider the control risk related to such risks.
59. In debating whether this second filter may be appropriate, the WG specifically considered whether stakeholders would be of the view that higher inherent risks, which are not difficult for management to control, however management fails to control, or has chosen not to control, are risks of material misstatement that the auditor should be including as an identified and assessed significant risk. The WG is of the view that this may be the case and, if so, a secondary filter of "management fails to control, or has chosen not to control" may be appropriate to introduce in the auditor's identification and assessment of significant risk. The WG however recognizes that the inclusion of the consideration of controls would be a substantial change to the concept of significant risk and may have the consequence of introducing additional complexity in an area where diversity in practice already exists.

Items Identified for Further Consideration by the WG

60. Prior to exploring further the possibility of including a second filter to introduce the consideration of control risk in the auditor's identification and assessment of significant risk, the WG would like the O CAG Representatives and Observers' views on the matter. However, from the WG's discussions to date regarding this possibility, the WG has identified items that would likely need to be considered further. For example, if the auditor should take into account control risk as part of the identification and assessment of significant risk:
- Does this create the need for a more extensive understanding of control activities as part of risk assessment for the auditor to be able to do so?
 - Or could the auditor's understanding of internal control relevant to the audit (as set out in **Section II**) be sufficient

Matter for CAG Representatives and Observers' Consideration

9. What are CAG Representatives and Observers' views on whether the WG should explore a second filter to introduce the consideration of control risk in the auditor's identification and assessment of significant risk (including consideration of the implication that this would have on the requirement in paragraph 27 of ISA 315 (Revised) that "the auditor shall exclude the effects of identified controls related to the risk")?

Implications of WG recommendations to ISA 330

61. The WG has determined that if the proposed changes to ISA 315 (Revised) regarding the identification of significant risks were to be made, there would be a need for consideration of consequential amendments to ISA 330.
62. If an identified risk of material misstatement is determined to be a significant risk due to higher inherent risk and that based on its nature, the risk is difficult for management to control, then:

- (a) The auditor should be less willing to rely on evidence from tests of controls as the primary source of audit evidence;
 - (b) The auditor's response to the significant risk needs to correlate to what it is about the assessed risk that makes it a higher risk of material misstatement; and
 - (c) Likely result in a change in the nature of the evidence the auditor will need to obtain when testing the significant risk (i.e., the evidence will need to be more persuasive).
63. If an identified risk of material misstatement is determined to be a significant risk due to higher inherent risk and management fails to control, or has chosen not to control, then the auditor would need to respond to the significant risk through substantive procedures that are more persuasive and correlate to the assessed risk (i.e., this is the inverse of the risks that substantive procedures alone are not enough, it is the risks for which tests of controls are not an appropriate response).

Specific consideration for audits of SMEs

64. The WG is of the view that the clarifications above related to the use of factors to assist in the assessment of inherent risk (in paragraph 50 above) and the auditor's consideration of the filter of difficult for management to control when identifying significant risk are equally helpful in audits of all sizes.
65. The auditor's consideration of a second filter, management fails to control, or has chosen not to control (if the IAASB and CAG Representatives and Observers agree should be further explored), would need to be further considered for the effect on audits that take a fully substantive approach. The WG recognizes that requiring a greater understanding of control activities in order to assess significant risk has consequences to the scalability of understanding internal control relevant to the audit.

Items Identified for Further Consideration by the WG

66. In relation to the auditor's determination of significant risks, there are a number matters which the WG is still to further consider also taking into account the CAG Representatives and Observers views of the WG recommendations. These include:
- Further development of guidance around the concept of "difficult to control."
 - Further consideration of the need for guidance to assist auditors understanding how the factors of risk in paragraph 50 above inform the identification and assessment of inherent and significant risk.
 - Effects of how the factors of risk in paragraph 50 above impact fraud risks and other presumed significant risks (and whether presumed significant risks should be retained).
 - Further consideration of the effects on the auditor's response to significant risks in ISA 330.
 - Whether proposals related to significant risk are compatible with other standards, including those noted in paragraph 11(c) of **Agenda Item 3-A**.

V. Spectrum of Risk

67. For those risks of material misstatement that are not identified as a significant risk, there is no mention in ISA 315 (Revised) of whether the significance of the risk of material misstatement for those non-

significant risks are equal, or whether those risks of material misstatement should be considered as being on a spectrum of risk (see discussion in paragraph 45 above).

68. In responding to the identified and assessed risks of material misstatement, ISA 330 states that the objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Issues

69. One of the questions that has arisen in practice and has been raised in the WG's outreach activities and discussions is whether there is 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. In practice, some auditors have determined that ISA 315 (Revised) implies that there is a 'spectrum of risk,' and therefore that audit procedures to address risk is not only focused on significant risks, while others have the view that audit effort should be focused on significant risks.
70. Within the ISAs, there are a number of areas²¹ where terms related to risks such as "higher risk of material misstatement," "higher risk," "assessed risk is high," and "assessed risk is lower" exist, and may therefore suggest that there may be a range of risks of material misstatement.

WG Recommendations

71. By stating explicitly in ISA 315 (Revised) that a 'spectrum of risk' relating to the assessment of the risk of material misstatement exists, this would clarify that while the responses to the risks of material misstatement other than significant risks may not be as intense as the response to a significant risk, those non-significant risks need to be responded to appropriately, and the extent or intensity of that response would likely vary.
72. It is not the intention of the WG that a 'spectrum of risk' would include additional categories of risk, as this would add unnecessary additional complexity.
73. Prior to the WG exploring a 'spectrum of risk' further, the WG would like the CAG Representatives and Observers to provide reactions to the possibility of explicitly including in ISA 315 (Revised) the concept of a spectrum of risk.

Matters for CAG Representatives and Observers' Consideration

10. Are CAG Representatives and Observers supportive of the WG continuing to explore the possibility and potential consequences of a 'spectrum of risk' in ISA 315 (Revised)?
11. What, in CAG Representatives and Observers views, are other factors or implications the WG should consider regarding the possibility of including a "spectrum of risk" within ISA 315 (Revised)?

²¹ ISA 300, *Planning an Audit of Financial Statements*, Appendix; ISA 330, paragraphs A9 and A10; ISA 530, *Audit Sampling*, Appendix; ISA 550, *Related Parties*, paragraph 2; ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph A30.

VI. Way Forward

74. The WG is intending to move forward with the project as follows:
- (a) Continue to coordinate with the ISA 540 Task Force on matters related to the ISA 540 project that are likely to impact or be impacted by the ISA 315 (Revised) project. In particular, close and timely coordination on matters related to assessing risk and significant risk and the required extent of understanding of components of internal control.
 - (b) Taking into account the input received from the IAASB and the IAASB Consultative Advisory Group at their respective September 2016 meetings, continue to develop thinking related to matters addressed in this paper. This would include further consideration and discussion of the areas noted in sections in this paper titled 'Items the WG still needs to consider' and further consideration of matters related to spectrum of risks (subject to IAASB feedback).
 - (c) At the December 2016 IAASB meeting, provide further drafting suggestions for IAASB consideration related to the matters noted in this paper and bring additional issues for discussion.
75. The topics of discussion in this paper do not represent all of the issues the WG will be considering in the ISA 315 (Revised) project. For the next two IAASB meetings (i.e., December 2016 and March 2017), the WG intends to discuss and bring to the Board for input (or further input, as applicable) the following issues (in no particular order):
- (a) For Matters for CAG Representatives and Observers' Consideration and other specific activities planned by the WG as noted in this paper, further thinking from the WG in light of the views expressed by the IAASB and CAG Representatives and Observers at their respective September 2016 meeting;
 - (b) Understanding the entity and whether further clarification within ISA 315 (Revised) could assist auditors in connecting the understanding gained to the assessment of risk;
 - (c) Whether amending the structure of the standard would improve effective execution;
 - (d) Revisit the objective of the standard;
 - (e) Explore whether requiring the identification of significant accounts and disclosures and their relevant assertions as an additional requirement when assessing risk would enhance the quality of auditor risk assessments; and
 - (f) Further discussion on matters related to information technology (IT), such as:
 - (i) When are IT general controls relevant to the audit, particularly in the context of the environment of complex IT and financial reporting systems, electronic audit evidence etc.
 - (ii) The relationship between IT general controls and application controls.
 - (iii) The extent of the auditor's consideration of IT in assessing whether there are risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.

Matter for CAG Representatives and Observers' Consideration

12. Are there additional items that CAG Representatives and Observers believe should be prioritized by the WG over the course of the next two IAASB meetings?