

### ISA 315 (Revised)<sup>1</sup>—Issues and Recommendations

#### Objective of the IAASB Discussion

The objective of this agenda item is to obtain the Board's views on the proposed revisions to the requirements of ISA 315 (Revised) as set out in **Agenda Item K.2**, to assist the ISA 315 Task Force ('the Task Force') in developing the exposure draft of ISA 315 (Revised) for discussion.

#### I. Structure of this Paper and Format of the IAASB Discussion

1. This issues paper should be read in conjunction with **Agenda Item K-2**, which sets out, in tabular format, the following:
  - *Column 1*: the extant requirements in ISA 315 (Revised).
  - *Column 2*: proposed changes to the requirements in ISA 315 (Revised) marked to extant (unless noted otherwise). These proposed changes are the Task Force's views on amendments to be made in light of previous Board discussions and decisions, as well as other amendments the Task Force believes are necessary to clarify the auditor's work effort in identifying and assessing the risks of material misstatement.
  - *Column 3*: a summary of related matters set out in the project proposal the Board agreed should be addressed.
  - *Column 4*: a summary of Board discussions or decisions relating to the particular aspect of ISA 315 (Revised).
  - *Column 5*: references to the relevant paragraphs explaining the changes in this issues paper

The Board's discussions at the September IAASB meeting will be focused on the proposed changes as set out in Column 2.

2. The Information Technology (IT) aspects will be separately presented at the October IAASB meeting. Placeholders highlighting those areas where it is expected that further changes will be proposed to address IT in identifying and assessing the risks of material misstatement can be found in **Agenda Item K.2**.
3. The Task Force will also consider how the application material can be restructured, enhanced or new application material developed to demonstrate scalability of the revised and restructured requirements. The application material will also include enhancements to reflect how data analytics techniques or technology may be used during the risk identification and assessment process, through the inclusion of examples of techniques.

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

4. The following matters are still being discussed and proposed changes to ISA 315 (Revised) relating to these matters will be presented later in 2017:
  - Risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (paragraph 30 of ISA 315 (Revised)).
  - Revision of Risk Assessment (paragraph 31 of ISA 315 (Revised)).
  - Documentation (paragraph 32 of ISA 315 (Revised)).
  - How to articulate changes to drive the auditor to a more challenging mindset and demonstrate professional skepticism when identifying and assessing the risks of material misstatement.
  - Other matters set out in **Agenda Item K.2**.
5. In working through the changes to the standard, in particular as the application material is enhanced and amended, the Task Force will continue to consider whether additional implementation guidance should be developed (e.g., providing examples in areas where illustrating the concept or matter would be helpful, for small and medium practices (SMPs) who have called for more consideration about implementation through illustrating what needs to be done by way of examples).
6. The Task Force's activities including outreach and coordination with other IAASB Task Forces or Working Groups can be found in the Appendix.

## **II. Matters Relating to the Proposed Changes in ISA 315 (Revised)**

**Title, Scope and Objective** (paragraphs 1 and 3 of ISA 315 (Revised))

### *Summary of Previous Board Discussions*

7. There have been no Board discussions on these specific aspects of ISA 315 (Revised).

### *Task Force Views on the Proposed Changes*

8. In the view of the Task Force, the extant requirements are overly focused on understanding the entity and internal control, and that by removing the focus on 'understanding' from the title, scope and objective, this recognizes the importance of the other risk assessment procedures that are more than understanding, such as the design and implementation of controls.
9. Further, the Task Force is of the view that understanding:
  - The entity and its environment;
  - The applicable financial reporting framework; and
  - Internal controlare all sufficiently important to be emphasized separately, which is different to the way that the standard is currently structured.
10. With regard to the objective, the proposed change will also ensure that the objective is outcome-based and underscores that identifying and assessing the risks of material misstatement forms the basis of the further audit procedures undertaken as required by ISA 330<sup>2</sup> and other ISAs.

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<sup>2</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

*Task Force Views on Changes to the Application Material*<sup>3</sup>

11. The Task Force is of the view that a link should be made in the scope section to existing paragraph A1 of ISA 315 (Revised) to highlight the ongoing, iterative nature of the process to identify and assess the risks of material misstatement.
12. The Task Force is still considering whether to make further changes to:
  - Make a stronger link to other relevant standards (e.g., ISA 200,<sup>4</sup> ISA 220<sup>5</sup> etc.) to illustrate the interaction of the risk assessment standard with these other standards.
  - Provide introductory material to explain the standard or aspects of the standard.

**Matter for IAASB Consideration**

1. The IAASB is asked for its views on the proposed changes to the title of the standard, and the scope and objectives paragraphs (i.e., paragraphs 1 and 3 of ISA 315 (Revised)).

**Definitions** (paragraph 4 of ISA 315 (Revised))

13. Matters relating to changes to the following definitions have been presented later in this paper to facilitate Board discussions:
  - Internal control and a new definition of ‘controls’—see paragraphs 42–46.
  - Significant risk—see paragraphs 86–87.

*Summary of Previous Board Discussions*

14. There have been limited Board discussions relating specifically to the definitions (with the exception of ‘significant risk’).
15. Related to the definitions in the standard, the Board has previously discussed:
  - Clarifying the terms ‘internal control,’ ‘controls,’ and ‘control activities,’ as there was inconsistent use of these terms in the ISAs resulting in confusion as to what each term means.
  - The qualitative inherent risk factors, and how these could be defined and integrated in the standard.
  - Introducing the concept of identifying significant account balances and disclosures.

*Task Force Views on the Proposed Changes*

**Assertions**

16. As previously discussed with the IAASB, the Task Force proposes that a new requirement be included for the auditor to identify classes of transactions, account balances and disclosures, and their relevant assertions, for which risks of material misstatement exist (see paragraph 82 explaining the process of identifying and assessing the risks of material misstatement—where the proposed requirement for the

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<sup>3</sup> Changes to application material have not been presented in these agenda papers – the descriptions of the possible changes related to the application material throughout this paper are provided for context.

<sup>4</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>5</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

auditor's identification of relevant classes of transactions, account balances and disclosures and their relevant assertions is discussed). In its discussions related to implementing this new requirement, the Task Force considered the extant definition and guidance related to assertions.

17. The specific assertions to be used in an audit are not defined in the requirements, rather the application material describes a set of assertions that may be used. The standard further explains that different assertions can also be used provided all aspects of the assertions in paragraph A129 of ISA 315 (Revised) have been covered. The Task Force does not propose changing this approach, however, is of the view that better describing what assertions are, in the context of their use in the audit as well as describing when they are relevant, will assist in supporting the new proposed requirement for the auditor to identify relevant assertions. Also, more generally, it will assist with the risk identification and assessment process at the assertion level.
18. In revising the definition of "assertion", the Task Force considered the extant definition and how it is connected to 'assertions' made by management. Some members of the Task Force believe that there is confusion as to what management asserts when preparing the financial statements and the assertions used by auditors. Accordingly, the Task Force has agreed that the relationship between the assertions made by management and those used in the audit could be better explained in application material. In addition, it may also be helpful to contrast management's assertions to representations made by management (for example as required by ISA 580)<sup>6</sup> in the application material.
19. Proposed revisions have been made to the definition to:
  - Better explain that an assertion is linked to a misstatement, i.e., that they are statements the auditor uses to consider different types of misstatements;
  - Define what a 'relevant assertion' is including that:
    - There is more than a remote likelihood that a misstatement in the assertion could be material. The Task Force deliberated about different possible 'triggers' that would make an assertion relevant, including 'reasonably possible' and 'possible,' but agreed that the appropriate threshold would be a 'more than a remote likelihood;' and
    - The determination is coupled with the determination of the relevant classes of transactions, account balances and disclosures (see next section).

#### Relevant Classes of Transactions, Account Balances and Disclosures

20. As previously discussed with the IAASB, the Task Force proposes that a new requirement be included for the auditor to identify classes of transactions, account balances and disclosures for which risks of material misstatement exist (see paragraph 82 for explanation of changes to the requirements). The Task Force has debated how to refer to, and define, these items in the financial statements. The Task Force believes that the appropriate term for these items is "relevant classes of transactions, account balances and disclosures" taking into consideration the IAASB's previously expressed concern about the use of the term "significant" and possible confusion with significant risks.
21. As it relates to determining the appropriate definition and threshold for "relevant classes of transactions, account balances, and disclosures," the Task Force discussed the interaction of this new term with the revised definitions of assertions and 'relevant assertions.' The Task Force concluded that a relevant class

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<sup>6</sup> ISA 580, *Written Representations*

of transaction, account balance or disclosure should be one for which there is at least one relevant assertion. That is, when a more than remote likelihood exists that a misstatement could be material related to an assertion, this would then give rise to a risk of material misstatement for the related class of transaction, account balance or disclosure. Further, because relevant assertions have been defined using a threshold of ‘a more than remote likelihood,’ the Task Force further confirmed its view that the term “relevant” is appropriate for these items because the term “significant” is inconsistent with, and would not appropriately reflect, the ‘more than remote’ threshold.

#### Risk Assessment Procedures

22. The same change has been made, for consistency, as described above relating to the title, scope and objective i.e., to delete “through understanding the entity and its environment, including the entity’s internal control.”
23. A change has also been proposed to modify “audit procedures performed...” to “audit procedures designed...” to be consistent with the articulation of the overall responses to the identification and assessment of the risks of material misstatement in ISA 330 (i.e., ISA 330 requires the auditor to design and implement responses...).

#### Qualitative Inherent Risk Factors (QIRFs)

24. As agreed by the Board, QIRF’s have been introduced to help the auditor better understand the characteristics that drive the identification and assessment of the risks of material misstatement. Accordingly, a new definition has been developed to describe the QIRFs, including specifying the factors that are included (i.e., complexity, ambiguity, change and uncertainty).<sup>7</sup>
25. The Task Force had previously proposed ‘susceptibility to fraud’ as a qualitative inherent risk factor, but was asked to reconsider whether this was necessary taking into account the specific requirements in ISA 240 and other related considerations relating to fraud when identifying and assessing the risks of material misstatement. After further deliberations, the Task Force agreed that the susceptibility to fraud is different in nature to the four other QIRF’s because when a risk of material misstatement due to fraud is identified, it is treated as a significant risk without regard to its relative likelihood or magnitude (i.e., risks of fraud are not assessed on a spectrum). For other risks of material misstatement, the impact of the other QIRFs fall on a range that then drives the assessment of risk, including the determination of whether the risk is a significant risk (this is further explained in the matters relating to significant risk in paragraphs 86–87). Accordingly the susceptibility to fraud has been removed as a QIRF.
26. The Task Force still needs to further consider the link to the qualitative inherent risk factors described in the exposure draft to ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* (ISA 540 ED)), in light of the comments received in the responses to the ISA 540 ED. The ISA 315 (Revised) Task Force will work with the ISA 540 Task Force to ensure that there is appropriate consistency between the standards.
27. The proposed changes in **Agenda Item K.2** have focused on incorporating the QIRFs into the standard, and the Task Force will continue to consider how this is most appropriately done, including

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<sup>7</sup> The Task Force is still deliberating the susceptibility to fraud as a QIRF, and the interaction with ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, but it has been included for the purposes of the discussions that follow relating to the QIRFs.

developing application material to help auditors understand their purpose and how to use them in identifying and assessing the risks of material misstatement.

#### **Matters for IAASB Consideration**

2. The IAASB is asked for its views on:
  - (a) Changes to the definition of assertions and other related changes; including:
    - (i) Whether the change clarifies the purpose of the assertions;
    - (ii) The revised definition for assertions; and
    - (iii) The new definition for 'relevant' assertion.
  - (b) The new definition of relevant classes of transactions, account balances and disclosures;
  - (c) The revised definition for risk assessment procedures; and
  - (d) The new definition of qualitative inherent risk factors.
3. With the exception of changes to the definitions discussed later in this paper (internal control, controls and significant risk) are there any other changes to the definitions that the Board believes is necessary, including whether there are other terms (not related to IT) that need to be defined?

#### **Requirements—Risk Assessment Procedures** (paragraphs 5 to 10 of ISA 315 (Revised))

##### *Summary of Previous Board Discussions*

28. There have been limited Board discussions on these specific aspects of ISA 315 (Revised).

##### *Task Force Views on the Proposed Changes*

29. The revisions to paragraph 5 have been proposed to clarify that the risk assessment procedures include:
  - Obtaining an understanding of the entity and its environment, and separately (as a focus area) on the applicable financial reporting framework.
  - Obtaining an understanding of internal control.
  - Identifying and assessing the risks of material misstatement, using the understanding obtained as a basis.
30. The revised paragraph 5 of ISA 315 (Revised) therefore sets out what needs to be done under the requirements of ISA 315 (Revised) thereby providing an outline of the set-up for the rest of the standard. Paragraph 6 then describes the 'techniques' that can be used to undertake the risk assessment procedures (i.e., inquiries of management, analytical procedures and observation and inspection). This revised presentation will, in the view of the Task Force, assist with the implementation of the requirements of the standard.
31. No changes have been made to paragraph 8, which requires the engagement partner to consider information from other engagements they have performed for the entity. The Task Force has deliberated whether to expand this requirement for the engagement partner to consider information from all engagements that the firm has performed, but agreed that extending this requirement to all engagements that the firm has undertaken may impose unnecessary burden on the engagement partner to understand

the findings or outcomes of all engagements, which may be impractical and may not in many cases provide information relevant to the risk assessment of the audit.

*Task Force Views on Changes to the Application Material*

32. Paragraph 6 of ISA 315 (Revised) sets out the techniques that can be used to perform risk assessment procedures. The Task Force will further consider how data analytics tools and techniques can be incorporated to update the application material associated to this requirement.
33. In addition, the Task Force intends to clarify, in the application material, how analytical procedures are used for risk assessment purposes versus the requirements in ISA 520<sup>8</sup> and ISA 330.
34. The Task Force will also continue to coordinate with the ISQC 1<sup>9</sup> and ISA 220 Task Forces for changes being made that may be relevant to ISA 315 (Revised) with regards to acceptance and continuance procedures.

**Matter for IAASB Consideration**

4. The IAASB is asked for its views on the proposed changes to the requirements relating to risk assessment procedures (i.e., paragraphs 5 to 10 of ISA 315 (Revised)).

**Requirements—The Required Understanding of the Entity and Its Environment, and the Applicable Financial Reporting Framework (paragraph 11 of ISA 315 (Revised))**

*Summary of Previous Board Discussions*

35. The Board agreed to separate the required understanding of the applicable financial reporting framework to give more prominence to the importance of this aspect.

*Task Force Views on the Proposed Changes*

36. Changes to the title are in line with the changes made to clarify the risk assessment process (i.e., the understanding of internal control has been separated to help the standard focus on each distinct aspect of the risk assessment process).
37. The requirement in paragraph 11 has been restructured and clarified to focus on those areas relevant to the entity and its environment, and emphasizes that all of the information is about enabling an understanding of the classes of transactions, account balances and disclosures expected to be in the financial statements. The Task Force has considered which aspects of an understanding of the entity and its environment are relevant, and has made changes in paragraph 11 to reflect this, including the Board's direction to incorporate an understanding of the 'business model.'
38. As previously agreed with the Board, understanding the requirements of the applicable financial reporting framework, alongside the auditor's understanding of the entity and its environment helps inform the auditor about where misstatements may arise, and is an important aspect of the process to identify and assess the risks of material misstatement. Paragraph 11 has therefore been revised to emphasize this focus separately. A new requirement has been developed to reflect the focus on this aspect of obtaining an

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<sup>8</sup> ISA 520, *Analytical Procedures*

<sup>9</sup> International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

understanding in the risk assessment process. The Task Force has also agreed that the considerations around the entity's selection of accounting policies is a different work effort (as it requires an evaluation of the appropriateness of those accounting policies relevant to the entity) and has therefore moved this to a new (separate) paragraph to distinguish it from the required understanding (as set out in paragraph 11A).

*Task Force Views on Changes to the Application Material*

39. As the Task Force develops and amends existing application material in relation to the required understanding, further consideration will be given to how this can incorporate a more challenging mindset of the auditor and the expectations that may be created, thus reinforcing professional skepticism throughout this process.
40. The Task Force will further consider how to reorganize and clarify the application material to help with implementation of the revised requirements, and develop new application material to:
  - Further explain how the auditor uses the required understanding in identifying and assessing the risks of material misstatement.
  - Further consider how scalability of the revised requirement can be demonstrated by providing examples of the required understanding of less complex entities, as well as examples for more complex entities.
  - Provide examples of how the 'business model' is relevant to different types of entities.
41. The Task Force will also consider application material to support the new focus on the applicable financial reporting framework, drawing from existing relevant application material (such as parts of extant paragraphs A32 and A35 of ISA 315 (Revised)).

**Matter for IAASB Consideration**

5. The IAASB is asked for its views on:
  - (a) The proposed changes to the required understanding of the entity and its environment (i.e., paragraph 11 of ISA 315 (Revised)).
  - (b) The new requirement for obtaining an understanding of the applicable financial reporting framework (paragraph 11A of ISA 315 (Revised)).

**Requirements—The Required Understanding of the Entity's Internal Control**

Definitions—Internal Control, Controls and Control Activities

42. Within the ISAs the terms 'internal control,' 'controls' and 'control activities' are not used consistently, and issues have been highlighted by a broad range of stakeholders that there is confusion in the standards as to what these terms mean. To address this, the Task Force has deliberated on how to make it clearer as to what each term means (and will make revisions throughout the standard to ensure that the correct term is used in the appropriate places).

43. As a result, consideration has been given to the definitions or descriptions of these terms in ISA 315 (Revised). In the view of the Task Force the definitions should be revised or new definitions created to explain the following:
- The entity's *internal control* refers to the whole system of internal control, which includes the five inter-related components of internal control.
  - *Components of internal control* include the control environment, the entity's risk assessment process, the entity's process to monitor controls, the information system (including related business processes) and communication, and control activities. Within each of these components, individual controls are embedded.
  - *Controls* are policies or procedures embedded in the components of internal control designed to achieve the control objectives of management. Policies are statements of what should be done to effect internal control. Procedures consist of required actions to implement the policies.
44. Accordingly the Task Force has proposed changes to the definitions as follows:
- (a) The definition of 'internal control' has been revised to clarify that it is the whole system (and can also be referred to as 'the system of internal control'), that the system is divided into the five components. Notwithstanding that the term 'process' is used in some internal control frameworks such as COSO, the Task Force agreed that a 'system' of internal control is more appropriate than 'process' as it emphasizes that it is a system that may consist of many parts that operate together and incorporates :
- Controls — the policies or procedures to achieve management's or those charged with governance's objectives.
  - Resources — human and technology.
  - Information — obtained, used or generated by the system.
  - Documentation —Evidence of the system's operation.
- (b) A new definition for 'controls' has been developed. In developing the definition, the Task Force believes that defining them as 'policies or procedures' rather than 'aspects' as used in the extant definition of internal control helps to clarify the meaning of controls 'relevant to the audit' and is easier for auditors to understand. The new definition also explains what policies or procedures are.
45. As 'control activities' is a component of internal control the Task Force is of the view that this does not need to be defined, rather that this component should be described (with changes as discussed in paragraph 73–76 below).
46. The Task Force also intends to develop application material to support the new and revised definitions to:
- Include examples of what the controls within each component could be;
  - Explain that policies can be documented, explicitly stated or in other management communications, or implied through management action or decisions; and
  - Explain the interrelationship between the components.

Changes to the Overall Requirement to Obtain an Understanding of Internal Control (paragraphs 12 and 13 of ISA 315 (Revised))

*Summary of Previous Board Discussions*

47. The following sets out the Board's decisions and discussions relating to internal control:

- It is important for the standard to explain why obtaining an understanding of internal control is relevant.
- Requirements for the understanding internal control to be made more scalable through developing examples and guidance to illustrate how the understanding can be obtained in different circumstances (e.g., through the use of examples to illustrate the difference between complex systems with lots of controls versus simpler systems with less controls)
- Make it clear that all components of control are relevant but the extent to which controls may be established by the entity in each component varies – emphasize the importance of understanding all components.
- Need to clarify the work effort for evaluating the design of controls relevant to the audit and determining whether they are implemented within each component of internal control (especially for audits that apply a primarily substantive approach).
- Make a stronger link between the overall requirement for understanding internal control and the requirements that address understanding each of the components, and make it clear that they are interconnected.
- Describe the impact the auditor's evaluation of the control environment may have on the auditor's decision to identify controls relevant to the audit that the auditor intends to test, and to include examples and guidance that address the variations in the formality of the control environment that may exist.

*Task Force Views on the Proposed Changes*

48. The Task Force has deliberated how to clarify the requirements relating to internal control so that it is clear what each term described in the standard relates to, and what procedures are required. In the view of the Task Force, and as described in paragraph 43 above, the system of internal control is divided into the five components of internal control (i.e., control environment, the entity's risk management process, the entity's monitoring of controls, the information system (including related business processes) and control activities), with each component comprising controls. To make this clear, paragraph 12 of ISA 315 (Revised) has therefore been revised to clarify that:

- The auditor's understanding of internal control is achieved through understanding the controls relevant to the audit within each component of internal control;
- The procedures to be performed to 'understand' each component are set out in the relevant paragraphs in the standard for each of the components, thereby making the link to the requirements that address the components of internal control that follow; and
- Obtaining an understanding of each component of internal control is done by evaluating the design and implementation of the controls within each component.

The current aspect of the requirement relating to whether a control is relevant to the audit has been maintained. Extant paragraph 13 of ISA 315 (Revised) has been combined with paragraph 12 to make clear that although most controls relevant to the audit relate to financial reporting, not all controls relating to financial reporting are relevant to the audit.

49. By making a stronger link between this overall requirement and the requirements that address the individual components of internal control, the Task Force is of the view that this will also clarify that each of the components of internal control is required to be considered. Through examples in application material, further clarification can be made when, for example, an entity may not have established controls within a particular component of internal control. For example, if an entity does not have a formal risk assessment process, further consideration should still be given to what may be in place to address the risks that a formal risk assessment process would address, and if there is nothing, whether a significant deficiency exists. The Task Force is also of the view that this clarification will help illustrate scalability of the requirements for smaller, less complex entities.
50. In addition to revising paragraph 12 of ISA 315 (Revised), and combining it with paragraph 13, the Task Force has revised the requirements that address understanding each component of internal control in order to provide clarity around how the auditor is to understand internal control as a basis for developing further audit procedures. In particular, the Task Force has clarified that for each component the auditor's work effort to understand the component involves identifying controls relevant to the audit within that component, evaluating their design and determining whether they have been implemented. The Task Force intends to develop application material for each of the components of internal control to illustrate how identifying and evaluating controls relevant to the audit may be done. This will enable auditors to better understand the nature and extent of work effort needed to demonstrate the required understanding.

#### *Task Force Views on Changes to the Application Material*

51. The Task Force will also further consider:
  - How to emphasize in the application material the benefits of obtaining an understanding of internal control, even if the auditor's intention is to undertake a primarily substantive approach to the audit.
  - Examples of controls for each of the components of internal control.
  - How to strengthen the link to Appendix 1 of ISA 315 (Revised) that provides further explanation about the internal control components.
  - How to make clear that in understanding the controls relevant to the audit, the other aspects of the internal control system should be considered (i.e., resources, documentation and information)

#### Changes to the Components of Internal Control (paragraphs 14 to 24 of ISA 315 (Revised))

##### *Summary of Previous Board Discussions*

52. It was noted there needs to be a stronger link between overall requirement to understand internal control and each of the components, and it should be made clear how they are interconnected.

*Task Force Views on the Proposed Changes*

53. The changes to paragraph 12 of ISA 315 (Revised) (as explained in paragraph 47–51 above) are intended to make the link between the overall requirement to understand internal control, and the components clearer. In addition, changes have been made:
- In the structure of the requirements for each component essentially to bring to life the new descriptions of components and controls, i.e., as noted earlier, the requirements for each component are no longer focused on understanding “the component” but rather the controls that comprise the component.
  - Clarify what needs to be done to ‘understand’ the controls within each component. This includes:
    - Explaining that obtaining an understanding of the controls within each component means identifying the controls, evaluating the design of those controls and determining whether they have been implemented.
    - Setting out that for the following three components of internal control the nature of the controls in each component are those specifically included in paragraphs 14,15 and 22 of ISA 315 (Revised):
      - Control environment;
      - The entity’s risk assessment process and
      - The entity’s process for monitoring controls.
    - Contrasting that for the following two components of internal control, judgment is used in understanding the nature of the controls in each component and depends the nature and circumstances of the entity and the audit:
      - The information system (including related business processes); and
      - Control activities.
54. The Task Force recognizes that the change in wording in the requirement within each component of internal control that requires the auditor to “understand” the component may be challenging to initially understand for, in particular, the control environment, risk assessment process and monitoring components (i.e., it may not be clear what “controls” are expected to be identified versus the current approach of understanding the component). The Task Force believes that the new proposed definition of “controls” is critical to a proper understanding of the revised wording of these requirements. That is, if the word “controls” is understood to be “policies or procedures” as explained in the definition, these revised requirements should actually help clarify what should be done. Auditors are familiar with the concept of policies and procedures, which should aid in their identification and evaluation of controls (i.e., policies and procedures) relevant to the audit.
55. The order in which the components have been presented, as well as the titles of some components, have been changed to help clarify what each component is, including:
- “Monitoring of controls”— changed to “the entity’s process to monitor controls” to illustrate the ongoing nature of the process, and has been advanced in ordering so that the three components that operate across the components of internal control , i.e., the control environment, the entity’s risk assessment process and the entity’s process to monitor controls, are presently first and separated from the components that primarily address controls over the generation of the classes

of transactions, account balances and disclosures in the financial statements i.e., the information system, including related business processes, and control activities.

- “Control activities relevant to the audit” has been changed to “control activities” to help clarify that it is the controls within the component that are relevant to the audit, and not the component itself.
56. IT aspects relating to the components of internal control are still being progressed and changes for these will be presented for Board discussion at the October 2017 IAASB meeting. In making changes, in particular in the application material, the Task Force will further consider how to illustrate the scalability of the requirements (for example, distinguishing between simple IT systems versus complex IT systems).

*Task Force Views on Changes to the Application Material*

57. The Task Force will also further consider how it can be made clear as to how the various components are interrelated.

Control Environment (paragraph 14 of ISA 315 (Revised))

*Summary of Previous Board Discussions*

58. The Board notes that there could be very different types of control environments and that the auditor's work effort could therefore be very different. The Board therefore suggested that this distinction in work effort be described and reflected in the examples and guidance developed.

*Task Force Views on the Proposed Changes*

59. Paragraph 14 of ISA 315 (Revised) has been:
- Reorganized to focus the auditor on evaluating the design and determining the implementation of the controls within the control environment, without losing the focus on controls presented in the extant standard.
  - Revised to set forth the scope of controls to be identified as relevant to the audit for all entities (i.e., those that are designed to maintain a culture of honesty and ethical behavior and to provide an appropriate foundation for internal control).
60. The Task Force is also of the view that the auditor should consider whether the control environment is appropriate to the entity's circumstances, or whether there is a significant deficiency in internal controls with regard to the control environment (see paragraph 14A). This mirrors the requirement in extant paragraph 16 of ISA 315 (Revised), which requires the auditor to consider whether there is a significant deficiency if the entity's risk assessment process fails to properly identify risks of material misstatement that the auditor has identified.

The Entity's Risk Assessment Process (paragraphs 15 to 16B of ISA 315 (Revised))

*Summary of Previous Board Discussions*

61. The Board has had very limited discussions about this specific component of internal control.

*Task Force Views on the Proposed Changes*

62. Paragraph 15 of ISA 315 (Revised) has been revised to focus on the evaluation of the design and determination of the implementation of controls within the entity's risk assessment process. Changes for

specific auditor considerations about the entity's risk assessment process include to set forth the scope of controls relevant for all audits and:

- Clarify that it is all risks related to financial reporting objectives, not only 'business' risks.
- Clarify that the significance of the risks is 'assessed' rather than 'estimated.'
- Include considerations about IT (placeholder).

63. Paragraph 15 of ISA 315 (Revised) assumes the entity has a 'formal' risk assessment process. The Task Force is of the view that even if the entity does not have a 'formal' process, management would still likely assess risks and implement controls to address these risks, and therefore the auditor should obtain an understanding about how this is done, including the policies (as relevant) and procedures, and make a similar assessment as would be done if there was a formal process – see revised paragraph 16 in **Agenda Item K.2**.
64. In addition, the Task Force believes that the auditor should consider the appropriateness of the entity's assessment of risks, when informal, in relation to the nature and circumstances of the entity, including whether this may be representative of a significant deficiency in internal control if it is not appropriate to the entity's circumstances— see paragraph 16A in **Agenda Item K.2**.

The Entity's Process to Monitor Controls (paragraphs 22 to 24 of ISA 315 (Revised))

*Summary of Previous Board Discussions*

65. The Board has had very limited discussions about this specific component of internal control.

*Task Force Views on the Proposed Changes*

66. Changes have been proposed to focus the auditor on the evaluation of the design and determination of the implementation of the controls relating to the entity's process to monitor controls.
67. With regard to paragraph 23 of ISA 315 (Revised), the Task Force discussed whether this should be changed (i.e., to be controls-focused) but agreed that this requirement is relevant to the auditor's work under ISA 610 (Revised 2013)<sup>10</sup> and is understood in that context (i.e., changes related to the use of internal audit are out of scope and not noted as an issue in practice due to fairly recent revisions to ISA 610 (Revised 2013).
68. Paragraph 24 of ISA 315 (Revised) relating to the sources of information used in the entity's monitoring process will be further considered in light of additional considerations relating to IT, and accordingly further changes may be made.

*Task Force Views on Changes to the Application Material*

69. In developing application material to support the revised definition, the Task Force is of the view that this should include material to explain that the entity's monitoring process:
- Should cover controls relating to monitoring controls within all of the components of internal control.
  - Can be ongoing or at a point in time, and explain that entities will have a combination of activities for it to be effective (which will also be consistent with changes being proposed to ISQC 1).

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<sup>10</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

The Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication (paragraphs 18 to 19 of ISA 315 (Revised))

*Summary of Previous Board Discussions*

70. The most significant Board comments relating to this component relate to IT aspects – these will be discussed with the IAASB in October 2017.

*Task Force Views on the Proposed Changes*

71. Some initial changes have been proposed as follows:

- To focus the auditor on the evaluation of the design and determination of the implementation of the controls in the information system.
- Controls related to journal entries has been moved to the ‘control activities’ component, which sets out specific controls relating to this aspect that are relevant to the audit.

In addition, further changes are expected as the Task Force progresses its thinking in relation to IT.

*Task Force Views on Changes to the Application Material*

72. The Task Force is of the view that as application material is developed to support the revised requirements, consideration will be given as to how data analytics techniques and tools may be applied in meeting requirements of ISA 315 (Revised) through the use of examples.

Control Activities (paragraphs 20 to 21 of ISA 315 (Revised))

*Summary of Previous Board Discussions*

73. The most significant Board comments relating to this component relate to IT aspects – these will be discussed with the IAASB in October 2017.

*Task Force Views on the Proposed Changes*

74. Changes have been proposed to focus the auditor on the design and implementation of the controls by creating a list of controls relevant to the audit to clarify exactly which controls are to be included:
- Significant risks (promoted from application material – previously in paragraph A100 of ISA 315 (Revised)).
  - Risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (promoted from application material – previously in paragraph A100 of ISA 315 (Revised)).
  - Where the auditor plans to test the operating effectiveness of controls (promoted from application material – previously in paragraph A101 of ISA 315 (Revised)).
  - Journal entries (moved from previous requirement in paragraph 18 (f) of ISA 315 (Revised)).
  - As otherwise appropriate (i.e., those that are relevant in the auditors’ judgment). ‘Appropriate’ has been used as it focuses the auditor on other controls, which are not listed specifically, but that may be integral to the identification and assessment of the risks of material misstatement.
75. Changes to paragraph 21 of ISA 315 (Revised), relating to risks arising from IT, will be addressed in October 2017.

*Task Force Views on Changes to the Application Material*

76. To support the revised requirement, application material will be developed to:
- Provide examples of relevant controls, and what the auditor would need to do to evaluate the design and determine the implementation of these controls. The Task Force is of the view that this is particularly important to assist with the implementation of the standard.
  - Highlight that the decision to test the operating effectiveness is necessary in order to determine the controls relevant to the audit.
  - In relation to the controls deemed otherwise appropriate, to provide guidance about how to identify what these controls could be (including how the qualitative inherent risk factors impact the auditor's considerations), potentially through factors that could be considered such as:
    - The auditor does not have enough information to design substantive procedures.
    - The risks in the class of transactions, account balances or disclosures are likely to be higher.
    - There are new systems or there have been changes in the information system.
    - There is a lack of segregation of duties, etc.

**Matter for IAASB Consideration**

6. The IAASB is asked for its views on the following matters:
- (a) Are the definitions relating to internal control and controls clear?
  - (b) Do the revised definitions and other changes being proposed make it clear what the various concepts relate to (this includes that 'control activities' is a component of internal control)?
  - (c) The proposed changes to the overall requirement to obtain an understanding of internal control, in particular whether it is clear that controls are embedded in each component of internal control (i.e., paragraph 12 of ISA 315 (Revised)).
  - (d) The proposed changes to the five components of internal control, including the reordering.

**Requirements—Identifying and Assessing the Risks of Material Misstatement**

*Summary of Previous Board Discussions*

77. The Board agreed that:
- There should be separate inherent and control risk assessments, with consequential changes to ISA 200 as necessary, but to be cautious of overcomplicating these assessments as these requirements are developed.
  - The proposed QIRFs (complexity, ambiguity, change, uncertainty and susceptibility to fraud) may help identify inherent risks. The Board generally agreed to the QIRFs as proposed but asked that consideration be given to including susceptibility to fraud as a qualitative inherent risk factor, given the focus on fraud in ISA 240.

78. The Board asked the Task Force to further consider:

- Incorporating judgments around the likelihood and magnitude when considering risks of material misstatement.
- Exploring ‘spectrum of risk’ (i.e., from low risks of material misstatements to significant risks) and how this can be illustrated in the standard. However, in doing so the Board cautioned about making this too complex.

79. With respect to significant risks specifically:

- The board supported:
  - Retaining the concept of ‘significant risk.’
  - Revising the definition of significant risk to focus on the nature of the risk.
  - That the concept of significant risk remain a subset of inherent risk.
  - That significant risks are at the highest end of the spectrum of inherent risk, and added that this should be clarified in the standard.
- The Board asked the Task Force to further explore whether:
  - The definition of significant risk should include the relative likelihood and magnitude of misstatement, and nature of risk in the context of the qualitative inherent risk factors.
  - Inherent risks that have low likelihood of misstatement but high magnitude would be a significant risk. Initial discussions with the Board indicated mixed views and the Task Force agreed to consider this further.
- With regard to the definition of significant risk (i.e., the working definition being progressed), the Board suggested that:
  - ‘Difficult for management to control’ should not be included in the definition.
  - The working definition be kept understandable.
  - Further consideration be given to including ‘judgment.’
  - The auditor’s consideration of the inherent qualitative risk factors should be reflected.
- The Task Force was also cautioned about wholesale changes in this area.

#### *Task Force Views on the Proposed Changes*

80. Paragraphs 25 and 26 of ISA 315 (Revised) have been combined and revised to help clarify how information obtained in understanding the entity and its environment, the applicable financial reporting framework and internal control is used in identifying and assessing the risks of material misstatement.
81. The concept of identifying and assessing the risks of material misstatement at the financial statement level and assertion level has been maintained, but a separate assessment of inherent risk and control risk has now been incorporated. It has also been clarified that the identification of the risks of material misstatement is done through the process of obtaining the required understanding in paragraphs 11–24 of ISA 315 (Revised)).

82. Changes with respect to identifying the risks of material misstatement and assessing inherent risks include:

- The auditor's consideration of the qualitative inherent risk factors to help identify risks has been added (along with planned new application material to provide examples about how the different factors can be used in different circumstances).
- A new requirement to identify relevant classes of transactions, account balances and disclosures, and their relevant assertions. The newly developed definitions for relevant classes of transactions, account balances and disclosures (see paragraphs 20–21) and relevant assertions (see paragraphs 16–19), together with planned new application material explaining what these new concepts mean, will help with the implementation of this new requirement, which, in the view of the Task Force, will help clarify how to identify the risks of material misstatement at the assertion level.
- Consideration of the likelihood and magnitude of a risk of material misstatement related to the relevant assertions that have been identified, helping the auditor to assess inherent risks related to the relevant assertion.
- The initial requirement to determine significant risks (which has also been moved to this requirement because, in the view of the Task force, this is part of the process to assess inherent risks).

The Task Force is of the view that these changes will better help auditors implement the requirements in a more consistent way.

83. The assessment of control risk has been separated as previously noted, and revised to:

- Require that identified controls that are relevant to the audit to be related to what can go wrong at the assertion level; and
- Consider the extent to which the controls related to each relevant assertion address the assessed inherent risk for that assertion (for example, if there is no control to address that assertion then control risk is maximum).

Application material will be developed to clarify that that this assessment of control risk will drive the auditors further audit procedures and is based on the expected operating effectiveness of the control (with the work performed on evaluating the design of the control and determining whether it has been implemented forming the basis of the auditor's assessment).

84. In addition, it will also be clarified in the application material that other controls identified as relevant to the audit that are not planned to be tested do not impact the assessment of control risk. Guidance will also be provided on how to apply identified controls to relevant assertions, as some controls may relate directly while others may not. In the view of the Task Force these changes will help clarify the work effort and what needs to be done relating to assessing control risk.

85. With regard to the identification and assessment of the risks of material misstatement, the Task Force still needs to consider any consequential changes to ISA 330 (in particular paragraph 18 of that standard) for changes made in ISA 315 (Revised).

**Matter for IAASB Consideration**

7. The IAASB is asked for its views on the proposed changes to the requirements for the identification and assessment of the risks of material misstatement, in particular the separation of the requirements

relating to the assessment of inherent risk and the assessment of control risk. (i.e., paragraph 25 to 25D of revised ISA 315 (Revised)).

### Significant Risks

86. The Task Force has further deliberated on the working definition of significant risks, and has revised the definition to reflect how significant risks should be identified taking into account the progressed thinking about how to identify the risks of material misstatement and assess inherent risk (i.e., using the QIRF's to help identify the risks of material misstatement and using the likelihood and magnitude of the possible misstatement). In the Task Force's view significant risks are those inherent risks:

- Where the assessment of inherent risk is higher due to the impact of one or a combination of the QIRF's (i.e., that the QIRF's drive the likelihood and magnitude of the possible misstatement to be higher), or
- That is required to be treated as a significant risk in accordance with the requirements of other ISAs (including ISA 240<sup>11</sup> and ISA 550).<sup>12</sup>

Changes to the definition have been made to reflect this thinking.

87. As discussed above, the initial requirement to identify significant risks, which require 'special audit consideration,' has been moved to paragraph 25B of ISA 315 (Revised), with the matters to be taken into account in identifying significant risk either being reflected in the definition or the revised requirement. Changes have also been made to paragraph 25C (previously paragraph 29 of ISA 315 (Revised)) to reflect the Task Force's changes in wording relating to understanding controls relevant to the audit. In addition, the Task Force has removed those risks listed in paragraph 28 of extant ISA 315 (Revised), as they either form part of the QIRF's or they are required by other ISAs to be treated as significant risks – both of these aspects are captured in the revised definition of significant risks as previously noted.

### **Matter for IAASB Consideration**

8. The IAASB is asked for its views on the revised definition of significant risk and related requirements in paragraphs 25B and 25C.

### **Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence**

88. This will be further considered by the Task Force as it progresses its work in relation to IT considerations. In addition, the Task Force will also consider whether there are other circumstances that should also be considered by the auditor in this area.

### **Matter for IAASB Consideration**

9. Are there any other matters for Task Force consideration as it further develops the exposure draft of ISA 315 (Revised)?

<sup>11</sup> ISA 240 paragraph 27 requires the auditor to treat those assessed risks of material misstatement due to fraud as a significant risk...

<sup>12</sup> ISA 550, *Related Parties*, paragraph 18 requires the auditor to...identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks...

**Task Force Activities Including Outreach and Coordination with Other IAASB Task Forces and Working Groups**

1. The following sets out the activities of the Task Force including outreach with others and coordination with other IAASB Task Forces and Working Groups relating to the ISA 315 (Revised) project.

**Task Force Activities since the last IAASB Discussion**

2. The ISA 315 Task Force has met three times in person and held two teleconferences since the last IAASB discussion in March 2017.

**Outreach**

3. The IAASB held one teleconference with the International Federation of Accountants (IFAC)'s Small and Medium Practices (SMP) Committee's IAASB Rapid Response Task Force to discuss changes being proposed to ISA 315 (Revised) and obtain their views from a SMP perspective.

**Coordination with Other IAASB Task Forces and Working Groups**

4. The Chair of the Data Analytics Working Group (DAWG) attended one ISA 315 Task Force meeting to discuss matters related to data analytics and how the changes being developed in ISA 315 (Revised) can reflect how data analytics tools and techniques are being used in identifying and assessing the risks of material misstatement. The Chair of the ISA 315 Task Force also held a teleconference with the Chair of the DAWG to discuss these matters.
5. The Task Force will hold a joint meeting with members of the ISA 540 Task Force in September 2017 to discuss matters in the responses to the ISA 540 ED relevant to ISA 315 (Revised), and how the projects can be progressed taking into account matters that are relevant to both projects.