

### ISA 315 (Revised)<sup>1</sup>—Initial Scoping

#### I. Draft Decision Summary – March IAASB Meeting

##### **Draft Summary of the IAASB's Discussions at Its March 2016 Meeting<sup>2</sup>**

Ms. Campbell provided an overview of the Staff paper included as **Agenda Item 3–A**, drawing the Board's attention to the background to the project, the post-implementation review findings related to ISA 315 (Revised) and anticipated interactions with other current IAASB projects. Ms. Campbell summarized the discussions at the March 2016 IAASB CAG meeting, highlighting that Representatives and Observers in particular noted that:

- Revisions to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) 2004 *Enterprise Risk Management – Integrated Framework* (ERM Framework) should also be considered.
- Further guidance was needed on the identification of significant risks at the component level in a group audit and the impact on the group audit when considering revisions to both ISA 315 (Revised) and ISA 600.<sup>3</sup>
- Consideration be given to how input could be obtained from small and medium practices (SMPs) in relation to the challenges in applying ISA 315 (Revised), as any revisions to this standard would significantly impact this stakeholder group.

Ms. Campbell highlighted feedback on **Agenda Item 3–A** received from the International Federation of Accountants (IFAC) SMP Committee, which noted specific challenges for SMPs in relation to risk assessment, in particular when auditing small- and medium-sized entities (SMEs), including:

- The requirement in ISA 315 (Revised) for auditors to understand and document the design and implementation of internal control where a wholly substantive approach is taken.
- The length and complexity of ISA 315 (Revised), including the resulting challenges in applying the standard to less complex audits or those that are have a less sophisticated information system / information technology (IT) environment.
- The need to update ISA 315 (Revised) for developments in IT noting that, in smaller and less complex audits, the auditor's understanding of simpler categorizations of controls (such as the control environment and control procedures) may be appropriate.

The Board agreed with the matters noted in **Agenda Item 3–A**, the input provided by IAASB CAG Representatives and Observers and the IFAC SMP Committee. Board members also encouraged that further consideration be given to:

<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*

<sup>2</sup> These draft minutes are still subject to IAASB review and may be subject to further change.

<sup>3</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

- In relation to internal control:
  - Inconsistencies in the application of ISA 315 (Revised) in identifying controls that are relevant to the audit, especially in the context of the audits of SMEs where a wholly substantive approach is taken. It was noted that, while the auditor may adopt a wholly substantive approach, this does not mean that no understanding of controls is required. Consideration should be given to whether the standard should include requirements reflecting certain minimum internal control elements that need to be taken into account in every audit, or at least additional guidance as to when some relevant controls should be assessed, especially in light of the increasing use of technology by entities.
  - Clarification of the work needed on IT general controls.
  - Whether the standard should include more on the monitoring of controls.
- In relation to understanding the information system relevant to the audit, it was also suggested that this project should explore the required understanding needed by the auditor in relation to the various sources of information used by the entity to prepare the financial statements, as well as how this information is processed. In particular, the IAASB noted a focus on information that is generated from outside the general ledger system (in light of the related discussions in the recently completed Disclosures project), the interaction with the current project to revise ISA 540, <sup>4</sup> and the impact of data analytics would be appropriate.
- The impact of the corporate governance structure on the flow of information used to prepare the information in the financial statements, and the related control structure.
- In relation to the identification of risks of material misstatement:
  - Whether this is done through obtaining an understanding of the entity, or if obtaining an understanding of the entity is a separate exercise distinct from identifying significant risks of material misstatement, as the standard is not clear.
  - Whether internal control impacts the assessment of the risks of material misstatement, as there are different interpretations as to whether they do or do not, in particular because certain paragraphs in the standard appear to be contradictory.
  - What the impact on the further procedures is in the spectrum of risks, as the standard only identifies significant risks but there may be other risks that are at the higher end of the spectrum, are not significant but require an increased response from the auditor.
  - Whether it is the whole account balance, class of transactions or disclosure that is considered a significant risk or only aspects thereof, as the audit response may be different.
  - Whether the number of significant risks should increase proportionately with the size and complexity of an entity.
- In relation to inherent risk, it was noted that ISA 315 (Revised) contains much application material related to the assessment of internal control, but minimal guidance on the assessment of inherent risk. One board member also noted that further guidance to assist auditors in assessing inherent risk, in particular in relation to what cannot be controlled by the entity (such as the entity's complexity, uncertainty and ambiguity in relation to the reporting framework) would be helpful.

- The interaction between the assessment of inherent risk and internal control. It was noted that there is diversity in practice whether to include internal control when assessing inherent risk as it is hard to bifurcate them, which was likely the result of a lack of clarity and inherent contradictions in certain of the requirements in ISA 315 (Revised). One board member suggested that ISA 315 (Revised) was initially intentionally drafted to not have a distinction between inherent risks and control risks, and such ambiguity was built in the standard so that different approaches could be taken (for example, the auditor could separately assess inherent risk then control risk, or consider inherent and control risk together). It was suggested that further consideration be given to whether this flexibility is no longer needed, or whether a more prescriptive approach might be required. In addition, it was suggested that a framework for assessing inherent risk within the standard may assist practitioners with some of the challenges encountered in this area, and may also help with the scalability of the standard.
- The need to reflect updates that have been made to the COSO *Internal Control – Integrated Framework* (2013), as well as to the ERM Framework, in ISA 315 (Revised). One board member noted that the requirements to consider the implications of the effect of IT in the auditor’s risk assessment process should be an integral part of the standard as opposed to the existing approach of an “add-on” consideration.
- The impact of professional skepticism on the auditor’s risk assessment process. It was suggested that language in certain of the requirements within the US Public Company Accounting Oversight Board’s (PCAOB) AS 12, *Identifying and Assessing Risks of Material Misstatement*, may encourage a more critical thinking mindset that could be incorporated into a revision of the IAASB’s standard.
- Cyber risks, so that the standard reflects the evolving environment more appropriately. However, one board member cautioned that the IAASB’s focus should be on how cyber risk impacts the financial reporting process only, as the topic is very broad.
- Whether the required understanding of the entity’s industry should be strengthened, together with the expected impact on the risk assessment process.
- Whether the impact of long association (i.e., senior personnel association with the audit client over a long period of time) on the auditor’s risk assessment process should be recognized in ISA 315 (Revised).
- Distinguishing between those issues that may indicate problems with the underlying standards compared to those that are related to implementation, to enable the IAASB to determine whether additional requirements, new application material or some other action is needed to address the issue.

It was also noted that, in making revisions to ISA 315 (Revised), the IAASB may also need to consider the potential implications to ISA 330<sup>5</sup> and ISA 240,<sup>6</sup> and possibly ISA 500.<sup>7</sup>

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<sup>4</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

<sup>5</sup> ISA 330, *The Auditor’s Responses to Assessed Risks*

<sup>6</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

<sup>7</sup> ISA 500, *Audit Evidence*

Board members provided suggestions for other sources of resources for information gathering on this topic other than those noted in **Agenda Item 3-A**. Specific mention was also made of the Institute of Chartered Accountants England and Wales (ICAEW) publication referenced in **Agenda Item 3-A**, particularly the section providing practical suggestions to address some of the challenges with ISA 315 (Revised) experienced by SMPs. While there was agreement that significant consideration should be given to the scalability of ISA 315 (Revised), the IAASB agreed that doing so should not result in the removal of requirements from the standard that would result in something less than an audit being performed.

#### IAASB CAG CHAIRMAN'S REMARKS

Mr. Waldron agreed with Ms. Campbell's summary of the comments received from CAG Representatives and Observers, adding that one additional suggestion noted was for further consideration about the work effort on risks that are not significant risks, in particular to distinguish the work effort on significant risks from the work effort on those areas where significant risks had not been identified.

#### WAY FORWARD

The Board agreed that certain aspects of the ISA 315 (Revised) project would need to be prioritized due to the interactions with the ISA 540 project, in particular the inconsistency in the nature and number of significant risks identified, identification of controls relevant to the audit, and risks and controls arising from information technology.

#### **Objectives of the IAASB Discussion**

The objectives of this agenda item are to:

- (a) Obtain input from the Board on the ISA 315 (Revised) Working Group's (the WG's) preliminary views on a project proposal; and
- (b) Obtain input from the Board on the WG's identification of the major issues to be addressed in a ISA 315 (Revised) project proposal.

## **II. Thinking to Date, including Framework for Project Proposal**

### *Background*

1. Risk assessment is fundamental to the audit process and is critical for the auditor in designing an audit strategy and approach that will be responsive to the risks of material misstatement. Risk assessment is about understanding what could go wrong and focusing the auditor's work effort on those areas of the financial statements being audited that are most susceptible to the risks of material misstatement. The audit risk model is used by auditors to manage the overall risk of an audit engagement. Auditors proceed by determining inherent and control risks, collectively the risks of material misstatement, pertaining to an audit engagement through gaining an understanding of the entity and its environment. Detection risk forms the residual risk after taking into consideration the inherent and control risks. Detection risk is the risk that the procedures performed by the auditor throughout the audit, 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.

2. Since the March 2016 IAASB meeting, the WG has discussed a number of the issues and challenges in the application of ISA 315 (Revised), including those identified in the ISA Implementation Monitoring Project. The WG has also discussed the implications of the significant changes in the economic, technological and regulatory aspects of the markets in which companies and audit firms operate, and recent developments in thinking in respect of internal control and risk assessment frameworks. As a result, the working group is of the view that consideration should be given to a broader revision of ISA 315 (Revised).

#### *ISA 315 (Revised) WG's Activities to Date*

3. The WG commenced its work in early March 2016 and undertook outreach activities to identify issues involving ISA 315 (Revised) to further inform its preliminary thinking. These outreach activities included leadership of the WG and staff discussions with representatives of the International Federation of Accountants (IFAC) Small and Medium Practices (SMP) Committee and the International Forum of Independent Audit Regulators' (IFIAR) Standards Coordination Working Group (SCWG). These outreach activities, the input received at the March 2016 IAASB and IAASB Consultative Advisory Group (CAG) meetings, and the WG's discussions to date, form the basis of the WG's preliminary thinking of the significant aspects of the ISA 315 (Revised) project articulated in this paper.
4. During the March 2016 IAASB meeting, the ISA 540 Task Force (TF) had a joint meeting with the WG, the Professional Skepticism Working Group (PSWG), and the Data Analytics Working Group (DAWG) to discuss common issues. Recognizing that ISA 540 sets out how ISA 315 (Revised) is to be applied in relation to accounting estimates, it was agreed that the ISA 540 TF will have to progress proposed changes to ISA 540 based on extant ISA 315 (Revised). Nonetheless, the ISA 540 TF will consider how the link between ISA 315 (Revised) and ISA 540 can be strengthened to avoid repetition and to better align language. The ISA 540 TF and the WG identified key areas for interaction that include: (i) how the current audit risk model in relation to significant risks model might change; (ii) whether some aspects of understanding the entity and risk assessment procedures relating to accounting estimates could be enhanced in ISA 540; and (iii) which standard should address the requests for more guidance on internal control over models, data and estimation processes and general Information Technology (IT) controls in relation to accounting estimates.
5. The WG has continued its coordination with the ISA 540 TF and the PSWG subsequent to the March 2016 IAASB meeting:
  - Leadership and staff of the ISA 540 TF and the WG have participated in one tele-conference to share views related to matters that cross over the ISA 540 and ISA 315 (Revised) projects.
  - Leadership and staff of the ISA 540 TF, the WG and the PSWG have participated in one teleconference to share views related to matters that cross over the ISA 540, ISA 315 (Revised) and professional skepticism projects.

*ISA 315 (Revised) Working Group's Preliminary Views on a Project Proposal*

Project Scope<sup>8</sup>

6. As evidenced from the input to the ISA Post-Implementation Monitoring project,<sup>9</sup> consultations on the [Work Plan for 2015-2016](#), outreach conducted by the WG to date, and the discussions at the [IAASB CAG](#) and the [IAASB](#) March 2016 meetings, there are areas where further consideration needs to be given to the requirements and guidance to enable auditors – auditing entities of all sizes – to effectively perform risk assessments in an increasingly complex environment.
7. Inspection findings by audit regulatory bodies and audit oversight bodies<sup>10</sup> have consistently highlight issues with respect to auditor's risk assessments. Audit deficiencies identified relate to insufficient risk assessment procedures, including inadequate involvement of the engagement partner<sup>11</sup> and the lack of evidence of the auditor's exercise of professional skepticism in the risk assessment process, and the extent of the auditor's understanding of the entity and its information systems, including the data underlying the financial statements.
8. It will likely be necessary for the IAASB to develop enhancements to ISA 315 (Revised) through a combination of revising the requirements as appropriate and enhancing the application material, or developing guidance, in order to respond to the issues and concerns raised. This will also include whether there are additional opportunities for scalability in the standard. Such revisions and enhancements may help address matters such as the need for ISA 315 (Revised) to:
  - (a) Reflect the current business and audit environment, and be sufficiently adaptable to deal with the rapidly changing business and audit environment;
  - (b) Be more effectively applied by the broad range of firms currently using the standard; and
  - (c) Set an enhanced foundation for other standards that have specific risk assessment requirements (such as ISA 540 and ISA 600<sup>12</sup>).
9. The WG is also of the view that the project should seek to make the principles-based requirements in ISA 315 (Revised) clearer, in light of feedback from auditors that many aspects of ISA 315 (Revised) are challenging to effectively and efficiently implement. Consideration will also likely need to be given to whether improvements in the organization, structure and workflow of the standard, in particular in relation to internal controls, are necessary to facilitate improvements in the effectively and efficiently applying the auditor's risk assessment procedures.

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<sup>8</sup> Other relevant ISAs that may be impacted by revisions to ISA 315 (Revised) are discussed further in paragraph X

<sup>9</sup> 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.

<sup>10</sup> [International Forum of Independent Audit Regulators Report on 2015 Survey of Inspection Findings](#)

<sup>11</sup> The role of the engagement partner is being more broadly explored with the IAASB's quality control project.

<sup>12</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

## Possible Project Objectives

10. The WG is of the view that the objectives of a project to revise ISA 315 (Revised) should be to:
- (a) Propose revisions to ISA 315 (Revised), clarifying and enhancing the requirements and application and explanatory material to foster audit quality by driving auditors to perform appropriate risk assessment procedures in audits of all sizes.
  - (b) Consider revisions to the standard that will emphasize the importance of professional skepticism in framing each of the judgements made by the auditor when performing risk assessment procedures.
  - (c) Determine the consequential amendments to other standards that are necessary as a result of revisions to ISA 315 (Revised) (such as ISA 240,<sup>13</sup> ISA 330, ISA 540 and ISA 600).
  - (d) Determine whether non-authoritative guidance and support tools should be developed to supplement revisions to ISA 315 (Revised) and to oversee the development of such guidance material as necessary. Non-authoritative guidance and support tools may include International Auditing Practice Notes, Staff publications, project updates, illustrations / examples to provide assistance on how ISA 315 (Revised) could be applied, including but not limited to the audits of small- and medium-sized entities ('SMEs' or 'smaller entities').

## Considerations Relevant to SMEs and SMPs

11. Several of the matters noted in the ISA Post-Implementation Monitoring project related to challenges experienced by those who perform audits of SMEs. Often, SMEs engage in relatively simple business transactions, which means that their audits under the ISAs will generally be less complex.
12. The ISAs include considerations specific to SMEs, which are intended to assist in the application of the requirements of the ISAs in the audits of such entities.<sup>14</sup> For example, in relation to requirements within various ISAs:
- They specify alternative procedures regarding understanding the entity's risk assessment process when the entity has not established such a process or it has an ad hoc process (a common observation in audits of SMEs).<sup>15</sup>
  - They specify a choice of audit procedures based on the particular circumstances. For example, a choice of responses to assessed risks for accounting estimates under ISA 540<sup>16</sup> where the option of using evidence arising from events occurring after the date of the financial statements is often an effective response in an SME audit, when such evidence is relevant to the accounting estimate and there is a long period between the date of the statement of financial position and the date of the auditor's report.

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<sup>13</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

<sup>14</sup> These additional considerations do not, however, limit or reduce the responsibility of the auditor to comply with the requirements of the ISAs. The 2009 IAASB Staff publication [Staff Questions & Answers - Applying ISAs Proportionately with the Size and Complexity of an Entity](#) further highlights how the design of the ISAs enables them to be applied in a manner proportionate with the size and complexity of an entity.

<sup>15</sup> ISA 315 (Revised), paragraph 17

<sup>16</sup> ISA 540, paragraph 13

- They indicate if a requirement is conditional, for example, where those charged with governance and management are the same (a situation often observed in SMEs).<sup>17</sup>
  - The application and other explanatory material in ISA 315 (Revised) contains a number of considerations specific to the audit of smaller entities.<sup>18</sup>
13. However, many auditors have noted challenges with the application of the ISAs to audits of SMEs. This feedback and other initiatives, such as the Nordic Federation of Accountants' proposal to develop a standard for audits of smaller entities,<sup>19</sup> suggests that it may not be sufficiently clear how the ISAs' risk-based approach can be appropriately applied to SMEs.
14. Notwithstanding the considerations for audits of smaller entities in the extant ISA 315 (Revised), in developing recommendations for improvements to ISA 315 (Revised), the WG will seek to make the requirements adaptable and scalable for audits of SMEs, and make the application of the standard more efficient by taking other steps to help auditors navigate the standard. In this regard, dialogue with the IFAC SMP Committee and other relevant SMP stakeholders will continue to be sought to obtain appropriate input at key stages of the project.

#### *Thought Process for the Working Group's Discussions to Date*

15. In discussing the challenges and issues that have been raised in the application of ISA 315 (Revised), the WG started with a comprehensive and integrated assessment of the practical steps that an auditor would undertake when performing the risk assessment process.
16. These discussions resulted in the WG categorizing the issues and challenges in the application of ISA 315 (Revised) into the following groupings, which are discussed in further detail in the referenced paragraphs:
- Understanding the Entity's Business and its Environment (18-24)
  - The Risk Assessment Process, and Identification of Higher Risk (25-28)
  - Internal Control and Control Activities (29-39)
  - Modernizing and Future-proofing (40-42)
  - Documentation of Risk Assessment Procedures (43)
  - Definitions, Language and Structure of the Standard (44-47)
  - Professional Skepticism (48-50)
  - Connection to Other Standards (51-56)

### **III. Major Issues to be Addressed in a ISA 315 (Revised) Project Proposal**

17. Taking into account the WG's discussions and outreach performed to date, without pre-judging any matters that the WG may bring to the IAASB for discussion in the project, the following represents the WG's preliminary categorization of issues that should be dealt with in the ISA 315 (Revised) project.

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<sup>17</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

<sup>18</sup> ISA 315 (Revised), paragraphs A17, A23, A48, A52, A56–A57, A84–A86, A88, A93, A95, A101–A102 and A108

<sup>19</sup> The [IAASB has responded](#) to the [Nordic Federation of Accountants'](#) initiative to explore ways to further support small and medium practices promote audits as a valued service for SMEs.

*Understanding the Entity's Business and its Environment*

18. Paragraph 3 of ISA 315 (Revised) states that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. The auditor achieves this objective through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.
19. Paragraph 5 of ISA 315 (Revised) requires the auditor to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. At the assertion level, risks of material misstatement consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.
20. While inherent risk and control risk are defined separately in the audit risk model, the auditor may in practice make separate or combined assessments of inherent and control risk depending on their preferred audit techniques or methodologies and practical considerations (ISA 200<sup>20</sup> paragraph A40). While the assessment may be performed in combination, inherent risk by definition is assessed before the consideration of any related controls. The combination of the inherent risk definition and the guidance in ISA 200 contribute to diversity and confusion in practice, with some auditors taking into account the consideration of related controls as part of the inherent risk assessment, while others do not. In practice, some auditors find it challenging to not allow the knowledge of internal control and past experience with the entity to influence the auditor's assessment of inherent risk. The WG will consider whether this area of potential ambiguity (i.e., whether the auditor should separately assess inherent risk then control risk, or should assess inherent and control risk together) should be addressed and whether a more prescriptive approach may be more appropriate.
21. ISA 315 (Revised) contains minimal guidance on how the auditor uses the information obtained in their understanding of the entity and its environment to undertake the assessment of risk. The WG has had a preliminary discussion about the possibility of introducing a 'drivers of risk' framework that would facilitate the auditor's assessment of risk (see **Diagram 1** that follows paragraph 22).
22. The WG is of the view that obtaining an understanding of the entity's:
  - Business model.
  - Applicable financial reporting framework (including the extent to which there are changes and its influence on the inherent complexity of, and ambiguity and uncertainty in recognizing and measuring, the financial statement elements and related disclosures).
  - Governance structure and higher order controls (control environment, risk assessment process and monitoring of controls).
  - External regulatory environment and industry.
  - Environmental and social impacts.
  - Strategies around opportunities and risks.

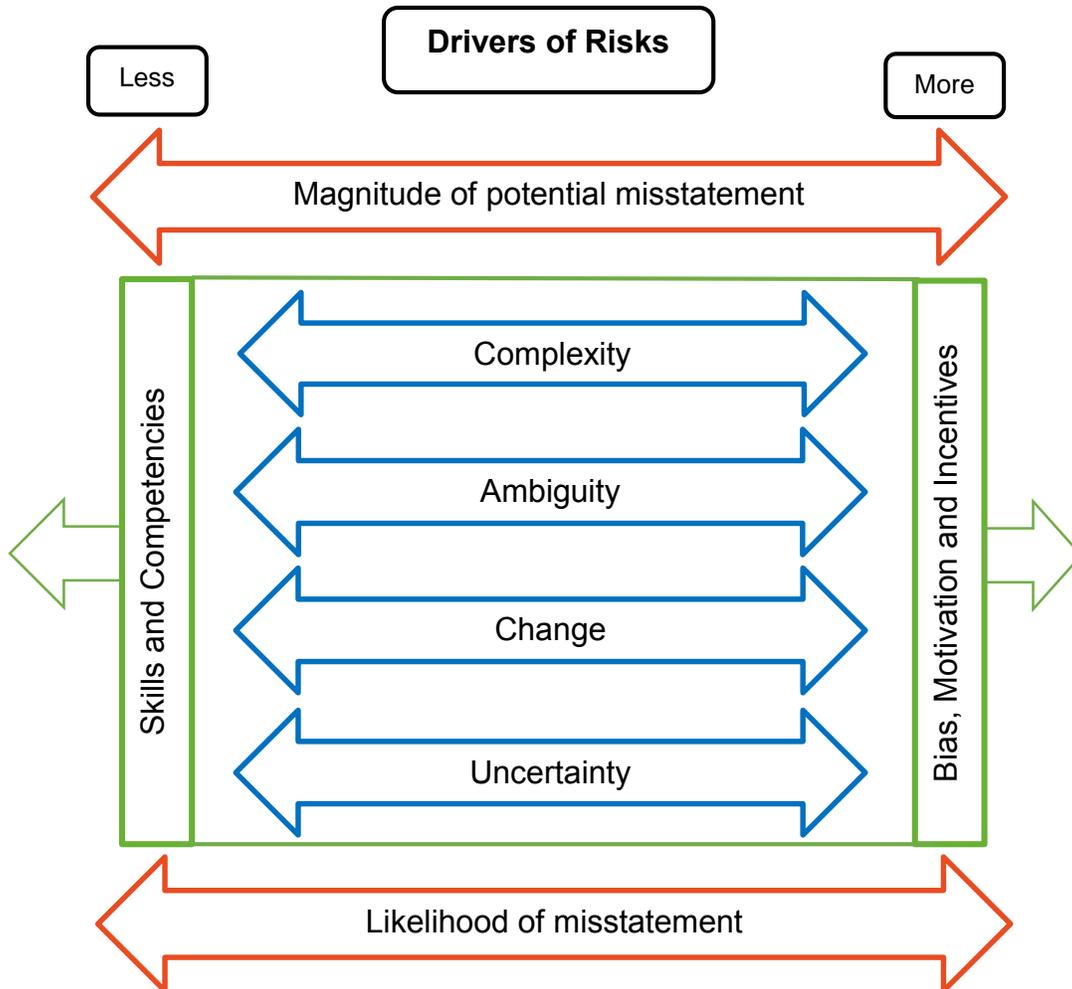
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<sup>20</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

- Financing structures and operations.
- Stakeholders and investments.
- Information systems (at a high level), including a broad overview of the role information technology (IT) plays in achieving the entity’s business objectives.

is likely to provide the auditor with sufficient information to perform an initial assessment of risk, or whether more is needed.

**Diagram 1**



23. The WG’s discussions to date have explored whether challenges with assessing risk results from a lack of clarity on how to document the information gathered when obtaining the understanding the entity.
24. In addition, the WG, working with the IAASB’s DAWG, will explore the impact of using data analytics when gaining the understanding of the entity and its environment as required by ISA 315 (Revised).

*The Risk Assessment Process, and Identification of Higher Risks*

25. ISA 315 (Revised) has requirements that the auditor identify and assess risks of material misstatement, including those that are significant risks.<sup>21</sup> The intent of identifying significant risks (those risks that require special audit consideration) is to identify risks that, by their nature, may pose an increased risk of material misstatement in the financial statements.
26. The WG discussions to date have focused on whether the significant risk concept in ISA 315 (Revised) is achieving the objective intended, and whether it should remain (with a revised definition focused on the nature of the risk rather than the expected audit response) or be replaced or removed. Feedback from a variety of stakeholders is 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.
27. The WG has had initial discussions on this matter, and formed a preliminary view that focusing on risks that by their nature pose an increased risk of material misstatement is a key element of performing an appropriate risk assessment. As such, the WG’s intention is not to remove the concept completely, but to challenge the definition and application of the concept as it is currently described in ISA 315 (Revised). The WG has shared this preliminary view with ISA 540 TF leadership to assist them in their deliberations.
28. Responses to the ISA Post-Implementation Monitoring project indicated inconsistencies in the number of significant risks being identified in practice. This has a consequential effect on the auditor’s work effort in responding to the risks of material misstatement. In addition to the matters noted in the ISA Post-Implementation Monitoring project, questions that arise in practice relevant to ISA 315 (Revised) include:
  - At what level should the risk assessment be done? At the financial statement line item level or at a level lower than the financial statements (e.g., at the account level)? And whether the concept of identifying significant accounts and disclosures (similar to how this concept exists in the U.S. Public Company Accounting Oversight Board risk standards) may facilitate risk assessment by providing a clearer connection to assessing the risk of material misstatement at the assertion level?
  - 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 significant risks receive a disproportionate level of the auditor’s work effort in relation to the level of effort dedicated to non-significant risk areas?
  - Should the number of significant risks increase relevant to the increase in size or complexity of the entity?

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<sup>21</sup> The handbook glossary defines significant risk as ‘an identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration.’

*Internal Control and Control Activities*

29. Paragraph 12 of ISA 315 (Revised) requires the auditor to obtain an understanding of internal control<sup>22</sup> relevant to the audit. The standard utilizes the following five components of internal control as a framework for auditors to consider how different aspects of an entity's internal control may affect the audit:
- (a) The control environment;
  - (b) The entity's risk assessment process;
  - (c) The information system, including the related business processes, relevant to financial reporting, and communication;
  - (d) Control activities; and
  - (e) Monitoring of controls.
30. The WG has had preliminary discussions about the extent to which each of the five components of internal control is relevant in all audits. The WG noted that some of the five components of internal control may, in principle, be relevant to all audits (information system and control activities, in particular), but may vary in the extent to which they are relevant to a particular audit. While understanding other (higher order) controls may be highly relevant in all audits in assessing the overall level of control risk that may have overall implications for acceptance of the engagement or for the audit strategy, in some audits there may however be relatively little to understand if the arrangements are simple and informal.
31. Paragraph 13 of ISA 315 (Revised) requires the auditor to evaluate the design of controls relevant to the audit and determine whether they have been implemented (by performing procedures in addition to inquiry of the entity's personnel). Feedback from auditors has indicated that further clarification is needed in ISA 315 (Revised) regarding what is meant by 'evaluating the design and implementation of controls relevant to the audit' (i.e., regarding the objective of the requirement and the nature and extent of the work effort required in meeting the requirement) and how this can be effectively achieved for each of the components of internal control.
32. Paragraph 20 of ISA 315 (Revised) requires the auditor 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 the assessed risks.
33. The purpose of requiring the auditor to obtain an understanding of internal control and control activities relevant to the audit is to provide the auditor with further input into understanding the entity's business and assessing risks arising from inadequate internal control.
34. Auditors, particularly those that perform audits of SMEs, note that the:
- Requirement to obtain an understanding of internal control and control activities relevant to the audit can be difficult to apply in practice;

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<sup>22</sup> The handbook glossary defines 'internal control' as 'the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.'

- Guidance on identifying controls that are relevant to the audit is not clear, and in some cases this can result in controls testing that does not address the identified risks of material misstatement;
  - Requirements in ISA 315 (Revised) related to understanding internal control and control activities are excessive if, as is the case on many audits of SMEs, a wholly substantive approach to testing is adopted; and
  - Requirement in paragraph 18 of ISA 315 (Revised) for the auditor to obtain an understanding of the information system, including the related business processes, relevant to financial reporting, is by itself sufficient in order to identify the risks of material misstatement (i.e., there are no control activities relevant to the audit when the auditor does not plan to test and rely on controls).
35. The WG:
- (a) Is of the view that the concept of ‘internal control and control activities relevant to the audit’ within ISA 315 (Revised) needs to be clarified to include the expected extent of understanding of internal control and control activities that is necessary in a wholly substantive audit approach.
  - (b) Will explore whether additional guidance is necessary to help auditors better understand the purpose for understanding internal control and control activities relevant to the audit, to address concerns that there is little value in doing so in a wholly substantive audit.
  - (c) Will consider whether updates to ISA 315 (Revised) are needed in response to updates to the Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) Internal Control – Integrated Framework (2013), which has been updated since the issuance of ISA 315 (Revised).
36. As noted in paragraph 40 below, ISA 315 (Revised) does not sufficiently reflect the complexity of the information systems used by many entities. The use of IT affects the way that control activities are implemented. From the auditor’s perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT controls<sup>23</sup> and application controls.<sup>24, 25</sup>
37. Feedback from the ISA Post-Implementation Monitoring project indicates that, because IT risks are not emphasized sufficiently in ISA 315 (Revised), general IT controls may not be tested sufficiently when reliance is placed on IT-dependent control activities. Questions have also arisen in practice regarding the extent of the evaluation of the design and implementation of general IT control activities required when performing a wholly substantive audit. In addition, there could be better linkage between the relevance of general IT controls and control activities such that even in an audit approach that may involve a combination of both a fully substantive approach for some accounts and a combination of a substantive and controls-reliance audit approach for other accounts, the auditor can effectively understand how to identify both relevant control activities and general IT controls. ISA 315 (Revised) could also be enhanced

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<sup>23</sup> IT general controls are policies and procedures that relate to many applications and support the effective functioning of application controls.

<sup>24</sup> Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

<sup>25</sup> ISA 315 (Revised), paragraph A103

to clarify the importance of the auditor understanding the relationship between general IT control activities and audit evidence. For example, when documents or data are used for the audit (i.e., as audit evidence) that are produced by the entity's information systems, what approaches can the auditor take to rely on that information when the design and operating effectiveness of general IT control activities are assessed by the auditor, and when they are not.

38. The WG is of the view that changes to ISA 315 (Revised) should be explored to acknowledge the potential complexity of the entity's information system and how the auditor would take such complexity into account in assessing the risks of material misstatement.
39. In addition, the WG, in conjunction with the DAWG, will explore whether a distinction should be made regarding the extent of work effort expected to establish the accuracy and completeness of data used for risk assessment purposes compared to when data is used for substantive analytical procedures.

#### *Modernizing and Future-Proofing*

40. Developments in technology, including the information systems used by entities to initiate, record, process and report transactions or other financial data, have been significant since ISA 315 (Revised) was first issued in 2003. Respondents to the ISA Post-Implementation Monitoring project noted that ISA 315 (Revised) is not sufficiently reflective of the complexity of the information systems used by many entities. Outsourcing of various aspects of an entity's information system, such as in cloud computing arrangements, has recently become far more prevalent, affecting entities of all sizes. There is also complexity around understanding the information that is obtained from outside of the general and subsidiary ledgers, as well as data or assumptions derived from outside of the entity that are used in determining estimates. For the latter, it may be difficult to identify when such information becomes part of the entity's information system and to what extent the auditor needs to understand the nature and source of the information.
41. The importance of the auditor having an appropriate understanding of the flow of information through the information system is increased as the information system used by the entity becomes more complex. The auditor's understanding of the flow of information including what could go wrong includes factors related to the IT utilized as well as human factors. The WG intends to explore how the complexity of the entity's information system could be more of a consideration in the auditor's assessment of the risks of material misstatement.
42. In executing the requirements in ISA 315 (Revised) to understand the entity's information system, including related business processes relevant to financial reporting, the auditor may trace transactions through the business process to understand the transaction flow. These procedures are currently performed primarily from discussions with management and others within the entity and by tracing a sample of transactions through the business process. Using data analytics, tools are available to analyze all transactions in a particular business process for a particular period, allowing the auditor to visualize all the paths transactions took. This allows the auditor to see what actually occurred, and not focus only on what should be occurring. Further consideration will be given to the impact of this on the risk assessment process and what, if any, changes may be needed in ISA 315 (Revised).

#### *Documentation of Risk Assessment Procedures*

43. Respondents to the ISA Post-Implementation Monitoring project indicated that more guidance is needed regarding the nature and extent of documentation for understanding the entity's business and internal

controls, in particular for the audits of SMEs. The WG discussed the extent of documentation from the risk assessment process and, whether from a practitioner's perspective, it is practical to require the auditor to document each use of the auditor's judgment, knowledge and experience. Further exploration of this is likely needed to determine whether changes to the standards should be made.

#### *Definitions, Language and Structure of the Standard*

44. There are a number of areas within ISA 315 (Revised) where the definitions and language used are not clear therefore resulting in confusion, misunderstanding and differing interpretations.
45. One example of this is in the area of controls. ISA 315 (Revised) makes references to the terms: internal control, internal controls, controls and control activities. These terms are used inconsistently within the standard, resulting in challenges for the auditor in interpreting the requirements of the standard, and also likely resulting in inefficiencies in documentation (as use of the different phrases has been interpreted to imply that there are separate documentation requirements in certain instances when that is not the WG's understanding of the intent of the standard).
46. The WG is of the view that further consideration should be given to the definitions and use of these terms in ISA 315 (Revised), thereby removing the uncertainty for auditors in applying the standard.
47. Respondents to the ISA Post-Implementation Monitoring project indicated that the organization of the standard is very complex, in particular in relation to internal controls, such that the requirements and guidance are difficult to implement in a work flow or logical sequence of risk assessment procedures. The WG will explore different ways in which to better reflect the interdependence of the requirements in gaining an understanding of the entity and its environment.

#### *Professional Skepticism*

48. Professional skepticism<sup>26</sup> is critical in the risk assessment process of an audit. If auditors inappropriately assess risks due to a lack of professional skepticism, all aspects of the audit are impacted and the whole audit could be ineffective. While professional skepticism is an attitude, this attitude is applied in making professional judgments that provide the basis for auditors' actions. Other relevant concepts in accounting, auditing and ethical requirements, including independence of mind and objectivity, competence as well as firm-specific and environmental factors may impact the application of professional skepticism.
49. Adopting and applying a skeptical mindset is a personal and professional responsibility for every auditor. The application of professional skepticism is influenced by personal traits, including fortitude (i.e., the strength of mind that enables the auditor to deal with matters arising during the course of the audit with courage), and the auditor's competence (e.g., knowledge, skills and experience). Strong views have been expressed by the IAASB CAG and at IAASB roundtables<sup>27</sup> about the importance of the auditor having a thorough understanding of the entity and its environment in order to facilitate a high-quality audit in which professional skepticism is appropriately applied.

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<sup>26</sup> Professional skepticism is defined in the ISAs as *an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence*

<sup>27</sup> IAASB roundtables conducted in connection with the IAASB's Invitation to Comment—*Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*

50. The WG, in conjunction with the IAASB's PSWG, will be exploring what can be done to re-emphasize the important role of professional skepticism in audits of financial statements, specifically related to risk assessment.

#### *Connections to Other Standards*

##### ISA 540

51. In December 2015, the IAASB approved the commencement of a standard-setting project to revise ISA 540. Matters to be considered by the ISA 540 TF that are likely to impact or be impacted by the ISA 315 (Revised) project include:
- The link between the degree of estimation uncertainty and complexity of an accounting estimate, and whether that accounting estimate is a significant risk.
  - Considering how unintentional and intentional management bias is taken into account in the auditor's risk assessment procedures.
52. The WG, in conjunction with the IAASB's ISA 540 TF, will be exploring areas for improvement in the risk assessment process, relevant to risk assessments associated with fair value measurements and other estimates.

##### ISA 600

53. In the context of a group audit, issues have been identified related to the identification of significant risks. These include:
- (a) Risks identified at the component level by the component auditors are sometimes not appropriately considered at the group level (i.e., inappropriate consideration is given as to whether such risks are group-wide risks or whether such risks also exist at some or all of the other components).
  - (b) In situations where group-wide significant risks have been identified that relate to all components, including non-significant components where no procedures are planned to be performed, it may be unclear as to where, or to which components, the work related to the significant risk is to be directed in order to appropriately respond to the risk.
54. The impact on group audits of any possible changes to significant risks will be further considered in the context of the project on group audits.

##### ISA 240 and ISA 330

55. The WG's discussions to date have explored whether it was possible to consider revisions to ISA 315 (Revised) without also considering the implications for ISA 240 and ISA 330. The WG's preliminary discussions have included whether ISA 315 (Revised) and ISA 240 could be combined, as in practice fraud risk assessment and risk assessment are interlinked and auditors generally consider these standards together during the audit. Further consideration of this will be needed before any proposals are put forward.

#### *Consequential amendments to other standards*

56. Any revisions to ISA 315 (Revised) would potentially result in consequential amendments to standards other than those noted above.

#### IV. Way Forward

57. The WG will physically meet in August 2016 to discuss the Board's feedback and further its thinking on prioritization of specific issues for the September 2016 IAASB CAG and IAASB meetings. The WG will liaise with the ISA 540 TF and develop a strategy to address the specific issues relevant to ISA 540 as a priority. The WG will also develop a timeline and a project proposal for approval by the Board at either the September 2016 or December 2016 meeting.

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

1. To help the WG develop a Project Proposal for ISA 315 (Revised), Board members are asked for their views on the following:
  - (a) Do Board members agree with the possible project objectives (paragraph 10)? If not, please explain why.
  - (b) Do Board members agree with the identification of the major issues (in **Section III**)? If you do not agree with a particular aspect, please explain why. Are there any major issues that have not been identified?
  - (c) Do Board members agree with the WG's proposed way forward, including the proposed timing for presentation of a project proposal for the Board's approval, taking into account that it may be beneficial to the ISA 540 TF for certain issues to be advanced prior to the approval of a ISA 315 (Revised) project proposal?
  - (d) Are there any specific considerations for SMPs or those that perform audits of SMEs related to the identified issues that have not been described in this paper? If so, please provide details and views about these matters.
  - (e) Are there any specific public sector considerations related to the issues described in this paper? Are there any other public sector considerations of which we should be aware? If so, please provide details and views about these matters.
  - (f) Are there any:
    - (i) Additional outreach activities the WG should consider?
    - (ii) Other specific matters or actions the WG should take into account? If yes, please provide details.