

ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment***Issues, Recommendations and IAASB Decisions to Date****Objective of the IAASB Consultative Advisory Group (CAG) discussion**

The objective of this Agenda Item is to obtain the Representatives' input on the International Standard on Auditing (ISA) 315 (Revised) Task Force's (the 'Task Force') proposals in relation to possible changes in ISA 315 (Revised).

The input from the Representatives on these matters will assist the Task Force in progressing the changes to ISA 315 (Revised).

Section I – Introduction to ISA 315 (Revised)*Background*

1. The ISA 315 (Revised) project originated from issues and challenges found as part of the IAASB's ISA Implementation Monitoring Project, and a project was planned and included in the IAASB's Work Plan 2015–2016.¹ The IAASB Working Group commenced initial work on ISA 315 (Revised) in March 2016. The IAASB discussed issues related to this initiative in March, June, September and December 2016, and the IAASB CAG discussed the initiative in March and September 2016.
2. The [ISA 315 \(Revised\) Project Proposal](#) (the Project Proposal) was approved at the IAASB's September 2016 meeting (taking into account comments made by the Representatives as appropriate), and the ISA 315 (Revised) Task Force (the Task Force) is continuing to progress discussions about possible changes to ISA 315 (Revised), with a view to developing the exposure draft for consultation in 2018.
3. This paper is intended to provide the Representatives with an update on the progress on this project since the discussions at the IAASB CAG September 2016 meeting. The paper provides a summary of the various topics that have been discussed with the IAASB at its September and December 2016 meetings, and where relevant, references to matters for discussion with the IAASB at its March 2017 meeting. The Task Force recommendations and IAASB decisions to date represent the current status of the project and are subject to change as possible amendments to ISA 315 (Revised) are progressed.

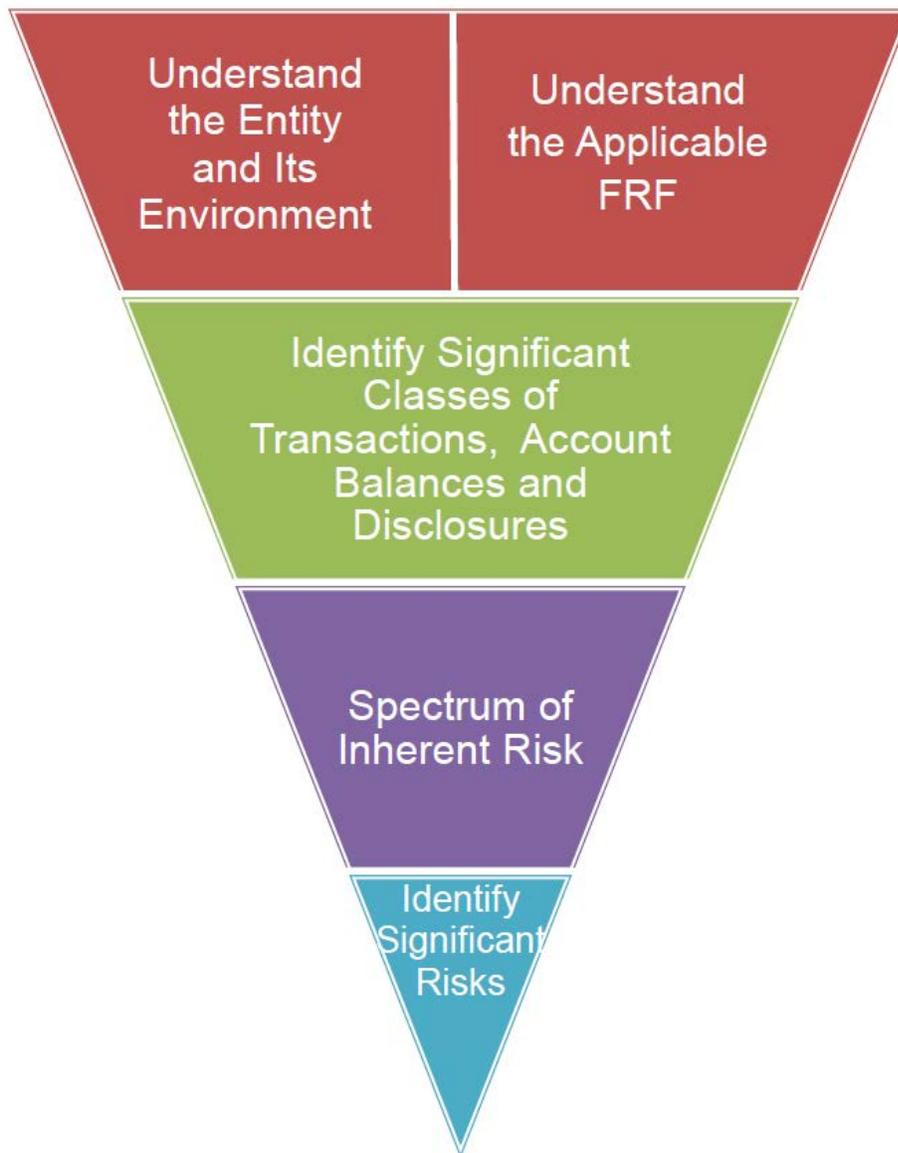
¹ Work Plan 2015–2016 <http://www.ifac.org/publications-resources/iaasb-work-plan-2015-2016>

Structure of this Paper

4. This paper explores issues and Task Force views and recommendations related to the following topics:
- (a) *Identification of inherent risks*—How the required understanding of the entity and its environment can more effectively result in the identification of inherent risks at the financial statement and assertion level. Specifically, whether (Section II, paragraphs 7–15):
 - (i) Further clarification is needed in ISA 315 (Revised) regarding the purpose of the auditor obtaining an understanding of the entity and its environment; and
 - (ii) More prominence should be given in ISA 315 (Revised) to the importance of the auditor obtaining an understanding of the applicable financial reporting framework (FRF).
 - (b) *Identifying significant classes of transactions, account balances and disclosures*—Exploring whether the introduction of the concept of the identification of significant classes of transactions, account balances and disclosures (similar to a concept that is used in the United States Public Company Accounting Oversight Board (PCAOB) standards) may assist auditors with identifying inherent risks at the assertion level, including assisting auditors with connecting inherent risks identified when obtaining an understanding of the entity and its environment to the relevant assertions (Section II, paragraphs 16–24).
 - (c) *Spectrum of risk*—Taking into account the feedback to date, further exploration of the explicit inclusion in ISA 315 (Revised) of a spectrum of risk and the use of qualitative inherent risk factors by the auditor in the identification and, in certain instances, assessment of inherent risks (Section II, paragraphs 33–41).
 - (d) *Significant risks*—Further consideration relating to determining significant risks based on the feedback to date (Section II, paragraphs 42–49).
 - (e) *Understanding of internal control*—Further consideration of matters relating to obtaining an understanding of internal control, specifically (Section III):
 - (i) An update on the Task Force discussions in light of the feedback to date on the purpose of the auditor obtaining an understanding of internal control and the relevance of the components of internal control to the audit; and
 - (ii) Initial Task Force views on issues related to the requirement in ISA 315 (Revised), paragraph 13, for the auditor to evaluate the design of those controls relevant to the audit and whether they have been implemented.
 - (f) *Other topics* to be discussed at the IAASB's March 2017 meeting (Section IV).
 - (g) *Other matters* discussed to date with the IAASB (Section V).

Section II: Identifying Inherent Risks, including Significant Risks

Overview of Task Force Views and Recommendations Related to Identifying Inherent Risks



5. This diagram depicts the Tasks Force's views regarding the actions the auditor would undertake to identify inherent risks, including significant risks. Each of these aspects is discussed further in this paper. As an overview, the auditor obtains an understanding of the entity and its environment – based on the extant requirement, but with greater prominence given to understanding the applicable Financial Reporting Framework (FRF). The auditor would use the understanding of the entity and its environment alongside the understanding of the applicable FRF to develop an expectation of the classes of transactions, account balances and

disclosures in the entity's financial statements and assist the auditor with the identification of inherent risks.² The auditor would then confirm their expectations by identifying the significant classes of transactions, account balances and disclosures, and their relevant assertions, in the entity's financial statements, assisting the auditor in identifying inherent risks at the assertion level. For the identified inherent risks, the auditor would determine which of the inherent risks are at the higher end of the spectrum of inherent risk, including those that the auditor determines to be significant risks. Throughout this process, the auditor will consider quantitative and qualitative risk

² The Task Force is of the view that additional information relevant to inherent risks may also be gained through the auditor's obtaining an understanding of internal control (see Section III of this paper for further discussion).

factors in the context of the nature and characteristics of the identified risks. With this overview in mind, the Task Force proposes to develop revisions to ISA 315 (Revised) that, in summary:

- (a) Give greater prominence to the requirement for the auditor to obtain an understanding of the applicable FRF and enhance how the auditor applies their understanding of the entity and its environment, alongside their understanding of the applicable FRF, to develop an expectation of the classes of transactions, account balances and disclosures in the entity's financial statements.
 - (b) Explain that the qualitative inherent risk factors (see paragraph 30 of this paper) can be used by the auditor, in conjunction with the auditor's understanding of the entity and the applicable FRF, in developing expectations about those areas of the financial statements that are susceptible to risks of material misstatement due to their nature.
 - (c) Require the auditor to identify "significant classes of transactions, account balances and disclosures" and their "relevant assertions".
 - (d) Require the auditor to assess which of the identified inherent risks are at the higher end of the spectrum of inherent risk, clarifying that significant risks are inherent risks that fall on the highest end of the spectrum of inherent risk.
6. Accordingly, the possible changes relating to the auditor's understanding of the entity and its environment (as summarized in paragraph 5 of this paper) in conjunction with the auditor's understanding of the entity's internal control, should be sufficient to enable the auditor to effectively assess the risks of material misstatement. While the Task Force has not yet fully considered all aspects of ISA 315 (Revised) regarding the auditor's understanding of internal control, the Task Force has further explored some aspects of this topic (see Section III of this paper).

Identification of Inherent Risks

Understanding the Entity and Its Environment

7. Paragraph 11 of ISA 315 (Revised) includes requirements for the auditor to obtain an understanding of numerous aspects of the entity and its environment. However, ISA 315 (Revised) contains minimal guidance on how auditors should use the information obtained in gaining an understanding of the entity and its environment.
8. The Task Force has explored whether challenges with identifying (and assessing) risks of material misstatement result, at least in part, from a lack of clarity on how to apply and interpret the information gathered when obtaining an understanding of the entity and its environment. The Task Force is of the view that the requirement for the auditor to obtain an understanding of the entity and its environment is for the auditor to gather information regarding risks that may give rise to and inform the auditor's understanding of inherent risks, and therefore may impact the auditor's assessment of the risk of material misstatement at the financial statement and assertion level. The Task Force refers to the auditor's procedures to address the requirement to obtain an understanding of the entity and its environment as the "top-down" approach to identifying inherent risks.



Greater Prominence on Understanding the Applicable Financial Reporting Framework

9. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable FRF. Accordingly, understanding the requirements of the applicable FRF in order to consider how those requirements may affect the risks of material misstatement of the entity's financial statements is important to the audit, yet it is not a particularly prominent aspect of paragraph 11 of ISA 315 (Revised). In addition, the Task Force is of the view that the auditor should use their understanding of the applicable FRF alongside the auditor's understanding of the entity and its environment to develop an understanding and an expectation of what information should be communicated in the financial statements and areas in the financial statements where misstatements are likely to arise (i.e., develop an expectation regarding the contents of the entity's financial statements, including many of the classes of transactions, account balances and disclosures, and potential related risks). However, the Task Force is of the view that this is not sufficiently explained in ISA 315 (Revised) and recommends the development of enhancements to the standard in this respect.
10. Adding greater emphasis to the requirement to understand the applicable FRF and clarifying its importance to the risk assessment process might be achieved by moving the extant requirement to obtain an understanding of the applicable FRF out of paragraph 11(a) of ISA 315 (Revised) and into its own separate paragraph under paragraph 11 of the standard. The Task Force will however continue to consider its re-positioning (e.g., possibly as a separate paragraph under paragraph 11 of ISA 315 (Revised) or integrating it into extant paragraph 11(c) of the standard).
11. In addition, the Task Force is of the view that the hanging text at the end of paragraph 11(b) of ISA 315 (Revised) "to enable the auditor to understand the classes of transactions, account balances and disclosures to be expected in the financial statements" should be moved to the introductory part of paragraph 11. Doing so would enhance all aspects of the required understanding (including the applicable FRF) and not just those noted in paragraph 11(b) of ISA 315 (Revised).



Applying the Qualitative Inherent Risk Factors in Obtaining an Understanding of the Entity and Its Environment, and the Applicable FRF

12. The Task Force is of the view that the auditor's consideration of the qualitative inherent risk factors (see paragraph 30 of this paper) during the process of the auditor obtaining an understanding of the entity and the applicable FRF, can assist the auditor in performing more robust risk assessment procedures during the audit.
13. The qualitative inherent risk factors can be used by the auditor to develop expectations about those areas of the financial statements that are susceptible to risks of material misstatement. By considering these risk qualitative inherent risk factors in the context of the requirements of the applicable FRF, the auditor should be able to develop expectations about the respective degree of complexity, ambiguity, change, uncertainty and susceptibility to fraud inherent in the classes of transactions, account balances and disclosures expected to be in the entity's financial statements. Further, by understanding changes in the requirements of the applicable FRF, the auditor can develop expectations about implications for the entity's financial statements. Similarly, changes in the entity could result in expectations for changes in how the requirements of the applicable FRF are applied to the entity's financial statements. These expectations would form the



outcome of the auditor’s work to understand the entity and its environment, and the applicable FRF, and would be the initial source of the auditor’s identification of inherent risks.

14. The Task Force recommends developing guidance for the application of the qualitative inherent risk factors in the auditor’s obtaining an understanding of the entity and its environment as well as the auditor’s obtaining an understanding of the applicable FRF.

IAASB Decisions to Date—Understanding the Entity and Its Environment

15. In expressing support for the Task Force exploring the matters discussed in paragraphs 7–14 above, the IAASB asked the Task Force to provide clarity as to how some of the proposals would be operationalized, which the Task Force will further consider.

Identification of Significant Classes of Transactions, Account Balances and Disclosures, and Relevant Assertions

16. Once the auditor has developed an expectation of the contents of the entity’s financial statements (as described in paragraphs 7–14 above), the Task Force is of the view that there is benefit to validating that expectation by identifying the “significant classes of transactions, account balances and disclosures and their relevant assertions” in the entity’s financial statements. The Task Force discussions to date have noted that in practice (and in the PCAOB’s risk assessment standards), in addition to the “top-down approach” to the identification of inherent risks discussed in paragraphs 7–14 of this paper, the identification of inherent risks may also have a “bottom-up” approach whereby the amounts and disclosures in the financial statements are used to identify those classes of transactions, account balances and disclosures and their relevant assertions susceptible to material misstatement.
17. Drawing on a similar requirement in paragraph 59(e) (and related paragraph 60) in PCAOB AS 12³ (see Appendix I for relevant extracts from PCAOB AS 12), the Task Force is of the view that a new requirement to identify the “significant classes of transactions, account balances and disclosures and their relevant assertions” would be helpful both in creating a link between the inherent risks identified as part of the auditor’s understanding of the entity and its environment and the auditor’s understanding of the applicable FRF to relevant assertions, and further identifying inherent risks that are specific to the classes of transactions, account balances and disclosures in the entity’s financial statements. Task Force members who have experience with audits where the PCAOB’s standards are applied have noted these benefits are realized in practice.
18. In the context of extant ISA 315 (Revised), identification of “significant classes of transactions, account balances and disclosures and their relevant assertions” could help auditors better understand and apply the requirement in paragraph 26(a) of ISA 315 (Revised) to identify risks of material misstatement “..by considering the classes of transactions, account balances, and disclosures in the financial statements.” This may help auditors in further understanding what is applicable in a similar reference in the requirement in paragraph 20 of ISA 315 (Revised) (emphasis added):



³ Public Company Accounting Oversight Board (PCAOB) Auditing Standard (AS) No. 12, *Identifying and Assessing Risks of Material Misstatement*

“An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.”

19. Paragraph 59(e) of PCAOB AS 12 requires the auditor, in identifying and assessing risks of material misstatement, to identify “significant accounts and disclosures and their relevant assertions.” Additional guidance related to paragraph 59(e) of PCAOB AS 12 notes that:

- An account or disclosure is significant based on its susceptibility to material misstatement;
- The susceptibility to material misstatement is judged both in terms of quantitative measures as well as qualitative factors; and
- The determination is based on inherent risk, without regard to the effect of controls.

Paragraph 60 of PCAOB AS 12 (see Appendix I) contains risk factors relevant to the identification of significant accounts and disclosures that comprise both qualitative inherent risk factors (similar to the qualitative inherent risk factors that the Task Force has identified (see discussion in paragraph 30 of this paper) and quantitative measures.

20. The Task Force expressed the view that the identification of significant classes of transactions, account balances and disclosures would provide auditors with a more robust framework for the requirements in ISA 315 (Revised) to identify and assess risks of material misstatement.⁴ Task Force members familiar with the PCAOB requirements for the formal identification of significant accounts and disclosures (the equivalent of significant classes of transactions, account balances and disclosures) have noted that in practice it creates essentially what can be viewed as a “backbone” for the risk assessment process. This “backbone” facilitates the auditor connecting both the inherent risks identified from the “top-down” procedures of obtaining an understanding of the entity and its environment and the applicable FRF, as well as those from the “bottom-up” consideration of inherent risks at the individual class of transactions, account balance and disclosure level, to their relevant assertions. This in turn enhances the auditor’s determination of the nature, timing and extent of further audit procedures that are both responsive to the risk assessments at the assertion level and necessary to obtain sufficient appropriate audit evidence.
21. The Task Force also noted that a concept similar to “significant classes of transactions, account balances and disclosures” is applied in the requirement in paragraph 18 in ISA 330.⁵ That paragraph states “irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.” The Task Force discussed feedback that the concept of “material classes of transactions, account balances, and disclosures” was often difficult to interpret, primarily because the concept of materiality in the ISAs is described in the context of misstatements and not in the context of financial statement items. It is difficult to explain what materiality means in this context. The Task Force considered that “significant classes of transactions, account balances and disclosures” may be easier

⁴ ISA 315 (Revised), *paragraph 25*. Additional guidance regarding risks of material misstatement is included in paragraph 13(n) of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. Paragraph 13(n) of ISA 200 defines inherent risk (underline added for emphasis) as “the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.”

⁵ ISA 330, *The Auditor’s Responses to Assessed Risks*

to apply because it would, as noted above, be based on the consideration of both quantitative and qualitative risk factors. In effect it would clarify that such items are those where there is a greater likelihood of material misstatement. The Task Force therefore intends to consider whether the reference to “material class of transactions, account balance and disclosure” in ISA 330 paragraph 18 should be replaced with “significant classes of transactions, account balances and disclosures.”

IAASB Decisions to Date—Identification of Significant Classes of Transactions, Account Balances and Disclosures and Relevant Assertions

22. The IAASB agreed with the Task Force’s recommendation to include in ISA 315 (Revised) the requirement to identify significant classes of transactions, account balances and disclosures, including that the auditor should consider a combination of quantitative and qualitative risk factors in identifying them. The IAASB agreed with the Task Force view that the qualitative inherent risk factors in paragraph 30 of this paper would be used as the basis for the risk factors that the auditor would need to consider for the qualitative aspect of identifying significant classes of transactions, account balances and disclosures. Determining the quantitative factors would be the subject of further discussion by the Task Force (having regard to quantitative-related factors highlighted in PCAOB AS 12 paragraph 60 – see paragraph 19 of this paper).
23. In expressing its support to include in ISA 315 (Revised) the requirement to identify significant classes of transactions, account balances and disclosures, the IAASB:
 - (a) Asked the Task Force to provide clarity as to how some of the proposals would be operationalized, particularly the recommendation to require the auditor to develop an expectation of the classes of transactions, account balances and disclosures expected to be in the entity’s financial statements and the consideration of the qualitative inherent risk factors in the identification of significant risks.
 - (b) Recommended outreach with the PCAOB regarding the proposal to require the auditor to determine significant classes of transactions, account balances and disclosures and their relevant assertions to gain insights on how this is applied in practice.⁶
24. The IAASB expressed mixed views regarding the Task Force’s recommendations related to paragraph 18 of ISA 330, i.e. change from using ‘material’ to ‘significant.’ This is because a change in terms may change the original intention of the standard—‘material’ means quantitatively large while ‘significant’ means either quantitatively or qualitatively significant, which may result in differences in the types of accounts that are identified to which this requirement applies.

Qualitative Inherent Risk Factors for the Identification of Inherent Risks

25. As noted in paragraphs 13–14 and 22 of this paper, the Task Force is of the view that, in identifying risks of material misstatement, the qualitative inherent risk factors previously discussed would assist the auditor in identifying inherent risks. The Task Force has continued to explore the qualitative inherent risk factors, including whether and how risks relating to fraud, management bias and data would be covered by the four qualitative inherent risk factors (complexity, ambiguity, change and uncertainty – see further discussion in paragraph 30).



⁶ A call was held with the PCAOB Staff about the use of ‘significant’ classes of transactions, account balances and disclosures, as well as further discussing the PCAOB’s risk standards more generally to further inform the IAASB’s deliberations in this area.

26. The Task Force specifically considered whether susceptibility to fraud should be added to the qualitative inherent risk factors. The Task Force recognized that fraud risk is outside the control of the entity (though may be perpetrated by management or employees) and concluded that it is a qualitative inherent risk factor, and therefore is recommending adding ‘the susceptibility to fraud’ to the qualitative inherent risk factors (see paragraph 30 of this paper). The Task Force also noted that this was consistent with the treatment of fraud risks as significant risks (since significant risks are inherent risks). The Task Force also noted that ISA 240⁷ defines fraud risk factors as “events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud”⁸ and also identifies another factor that is often present in cases of fraud – the ability of the perpetrator to rationalize the fraud.
27. In determining whether susceptibility to fraud should be an additional factor, the Task Force considered whether some or all of the qualitative inherent risk factors would also be present in circumstances where fraud risk factors were indicated. The Task Force concluded that there was likely to be some correlation between the presence of fraud risk factors and at least some of the other qualitative inherent risk factors because these other factors often provide an opportunity to commit fraud. However, the Task Force considered that, despite such correlation (and therefore some overlap) between these factors (complexity, ambiguity, change and uncertainty) and fraud risk factors, it would be appropriate for the auditor to specifically consider susceptibility to fraud (i.e. fraud risk factors) as an additional qualitative inherent risk factor.
28. The Task Force also specifically considered whether risks relating to management bias and data risk should be identified as separate qualitative inherent risk factors or whether the other factors would address circumstances where such risks would be indicated. With respect to management bias, the Task Force is of the view that intentional management bias is possible when management judgment is required to determine the information required to be included in the financial statements due to ambiguity (a degree of vagueness or a lack of clarity) in the applicable requirements. The Task Force therefore considered that management bias would generally be more likely when ambiguity was indicated and that management bias could be addressed through describing the nature of the risks that could be indicated when ambiguity is identified.
29. In relation to risks relating to data, the Task Force’s view was that these risks would not need to be identified through a separate inherent risk factor because data risks would likely be indicated by the presence of one or more of the other identified factors. For example, when a method is required to be applied in making a significant estimate that is complex because it requires multiple sources of large volumes of data, this could indicate risks to data integrity, particularly when such data would need to be sourced either internally from systems outside of the general and subsidiary ledgers or from external parties.
30. The five qualitative inherent risk factors, which include the four factors identified in the Project Proposal as well as susceptibility to fraud (see paragraphs 26–27 of this paper below), are described as follows:
 - Complexity: arises when there are many items or relationships among such items that require integration in applying depiction methods to determine information required by the FRF (e.g., using

⁷ ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

⁸ ISA 240, paragraph 11(b)

a complex model to determine a fair value, complex patterns of trading in financial instruments or complex supplier relationships for a retailer).

- Ambiguity: that results from a lack of clarity or a degree of vagueness in exactly what is required by the FRF, resolved by making an election or judgment about the appropriate information to include. Where the matter is more subjective, the judgment may be more susceptible to management bias.
 - Change: that results in changes in the information required by the FRF from one point in time to another during or between financial reporting periods – this includes changes in the FRF or in the entity or its business model or in the environment in which the entity operates.
 - Uncertainty: that arises from circumstances not within the control of the preparer of the financial information and that affect the determination of information required by the FRF and relate to the past, present or future condition of a transaction or event.
 - Susceptibility to Fraud: that results from fraud risk factors and is a quality or state of being susceptible to misappropriation of the entity’s assets or fraudulent financial reporting within the context of the FRF, including being susceptible to management override of control.
31. The qualitative inherent risk factors in paragraph 30 of this paper generally encompass the qualitative risk factors relevant to the identification of significant accounts and disclosures included in paragraph 60 of PCAOB AS 12 (see paragraph 19 of this paper).

IAASB Decisions to Date—Qualitative Inherent Risk Factors for the Identification of Inherent Risks

32. The IAASB expressed support for the Task Force’s continued consideration of the qualitative inherent risk factors. The IAASB however expressed mixed views regarding adding “susceptibility to fraud” as an additional qualitative inherent risk factor. Some IAASB members expressed support for its inclusion, while others suggested further consideration of the addition of susceptibility to fraud as a qualitative inherent risk factor as it appears to include aspects of both inherent risk and control risk. The Task Force has not further considered the feedback related to the addition of the “susceptibility to fraud” since the IAASB’s December 2016 meeting, but will do so and include updated views on them at a future IAASB (and IAASB CAG) meeting.

Spectrum of Risk

33. After exploring the process for the identification of inherent risks, the Task Force considered how the inherent risks identified relate to the concept of the spectrum of risk and the determination of significant risks, taking into consideration the feedback received to date.
34. The Task Force is of the view that the qualitative inherent risk factors in paragraph 30 above can, in addition to being used for the identification of inherent risk, also be useful in the assessment of inherent risks (at a minimum as it relates to determining significant risks). Specifically, the qualitative inherent risk factors can be used by the auditor to put into context the information obtained from risk assessment procedures to determine the extent to which an assertion is affected by one or a combination of the factors.
35. The risk assessment procedures performed by the auditor (understanding the applicable FRF, the entity and its environment and the entity’s internal control) provide a basis for the auditor’s



identification of inherent risks. If inherent risks were individually assessed, these would fall on a spectrum of inherent risks that would include a range from the lowest to the highest inherent risk, with the highest inherent risks being those determined to be significant risks. The Task Force is not suggesting that the auditor be required to make an assessment of where each inherent risk is on the spectrum of inherent risk. Instead, the Task Force is of the view that the auditor should perform an assessment of which of the inherent risks are at the higher end of the spectrum of inherent risks (consistent with extant ISA 315 (Revised)), for the purposes of identifying:

- (a) Inherent risks that the auditor determines to be significant risks; and
 - (b) Higher inherent risks, being those that are at the higher end of the spectrum of inherent risk but below those that are determined to be significant risks or have other characteristics, that the auditor determines (based on the auditor's judgment) it necessary to, for example, vary the nature and extent of work appropriately with the assessed risk of material misstatement or obtain an understanding of the control activities associated with that inherent risk.
36. The assessment of the identified inherent risks that fall at the higher end of the spectrum of inherent risk would be performed by taking into consideration the impact of the qualitative inherent risk factors, in addition to the likelihood and magnitude of the risk of misstatement. The nature and extent of work to respond to the assessed risk would vary accordingly.
37. The Task Force is of the view that explicit reference in ISA 315 (Revised) to a spectrum of inherent risk would assist the auditor with the identification of those risks noted in paragraph 35 of this paper. This will also address comments made by a Representative that the concept of significant risk does not mean that those risks that are not significant risks are automatically low risk.
38. In the context of the feedback received to date, the Task Force has recommended the following:
- (a) Inclusion in ISA 315 (Revised) of explicit reference to a spectrum of inherent risk, supported by application material to explain the intent of a spectrum of inherent risk, i.e., that the nature and extent of the response would be dependent on where on the spectrum the assessed risk is. Recognition of a spectrum of inherent risk in ISA 315 (Revised) would assist with the auditor's determination of significant risks and whether, in the auditor's judgment, it may be necessary to obtain an understanding of the control activities associated with that inherent risk, and also the determination of the nature and extent of further procedures to be performed. Further consideration will be given to how the spectrum of inherent risk relates to the risk assessment discussions in the ISA 540⁹ project.
 - (b) Development of application material to illustrate examples of risks on the spectrum of inherent risk. This application material will include guidance to assist the auditor with making judgments regarding where on the spectrum the respective risk is and to clarify that if an inherent risk is not identified as a significant risk it is not by default considered to be low risk.

IAASB Decisions to Date—Spectrum of Risk

39. While supportive of the Task Force continuing to explore the explicit inclusion of a spectrum of risk in ISA 315 (Revised), the IAASB noted that the Task Force be cautious to not introduce unnecessary additional complexity in the standard. Specifically, the explicit introduction in ISA 315 (Revised) of the

⁹ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

concept of a spectrum of risk should not result in ISA 315 (Revised) requiring a number of risk categories (other than what is already in the standard regarding significant risk), leaving it to practitioners to determine how their audit methodologies categorize risks (e.g., high, medium, low).¹⁰ The Task Force will continue to consider how this concept can appropriately be built into ISA 315 (Revised).

40. At the December 2016 IAASB meeting, the IAASB asked the ISA 315 (Revised) Task Force to also further consider whether a combined or separate assessment of inherent risk and control risk would continue to be permitted. This arose out of the discussion related to introducing a spectrum of inherent risk into ISA 315 (Revised) and whether such introduction would have an effect on the auditor's ability to perform a combined assessment of the risks of material misstatement, as permitted under ISA 200.¹¹
41. The IAASB will further discuss the separate and simultaneous identification and assessment of risks (i.e., inherent and control risk) at its March 2017 IAASB meeting.

Matter for IAASB CAG Consideration

1. Representatives are asked to provide views on the Task Force proposals and IAASB views set out in paragraphs 5–41 above. In particular, the Task Force would like to understand Representatives views on:
 - (a) Greater prominence to the requirement for the auditor to obtain an understanding of the applicable FRF.
 - (b) The qualitative inherent risk factors set out in paragraph 30, in particular the introduction of the susceptibility to fraud as a qualitative inherent risk factor.
 - (c) The possible new requirement for auditors to identify “significant classes of transactions, account balances and disclosures” and their “relevant assertions”.
 - (d) The assessment by the auditor about which of the identified inherent risks are at the higher end of the spectrum of inherent risk, clarifying that significant risks are inherent risks that fall on the highest end of the spectrum of inherent risk.

Significant Risk

42. The Task Force has discussed significant risk with the IAASB at its September and December 2016 meetings. To date, those discussions have resulted in the IAASB agreeing to the following related to significant risk:
 - (a) The concept of significant risk should be retained;
 - (b) Significant risk should continue to be a subset of inherent risks;
 - (c) Auditor judgment in the determination of significant risks should be retained (i.e., not having the ISAs specify issues that should automatically be considered significant risks in every audit (other



¹⁰ Any relevant changes made in ISA 540 will be considered for how they may impact ISA 315 (Revised).

¹¹ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

than what is currently in the ISAs for fraud risks related to management override of controls and revenue recognition));

- (d) The concepts that are addressed in the qualitative inherent risk factors in paragraph 30 of ISA 315 (Revised) should be retained as these continue to remain relevant in the auditor exercising judgment in considering which risks are significant risks;
 - (e) The definition of significant risk is circular and the Task Force should explore revising the definition with a focus on the nature of the risk;
 - (f) The qualitative inherent risk factors of complexity, ambiguity, change, uncertainty and susceptibility to fraud are helpful for the auditor to consider in the identification and the understanding of the nature of inherent risks, including significant risks, and in evaluating the relative likelihood and magnitude of the related risk (as discussed above in paragraph 30 above);
 - (g) Reference to the concept of “difficult for management to control”¹² should be considered for inclusion in application material in ISA 315 (Revised) and not within the definition or the requirements related to significant risk in the standard; and
 - (h) Significant risks will be those inherent risks that are the highest on the spectrum of inherent risks.
43. In addition to the items noted in paragraph 42 above, the IAASB has asked the Task Force to further consider:
- (a) In relation to the Task Force recommendation that the determination of significant risk should be based on the relative likelihood and magnitude of misstatement and on the nature of the risk in the context of the qualitative inherent risk factors (i.e., a high inherent risk driven by the relative likelihood and magnitude of misstatement and one or a combination of the qualitative inherent risks factors), whether a definition of significant risk that includes these concepts would sufficiently facilitate the auditor’s determination of significant risks given these concepts are relevant to the assessment of all inherent risks;
 - (b) Whether those inherent risks that have low likelihood of occurrence with high magnitude of impact give rise to a low likelihood of misstatement, but if that misstatement were to occur, it would be material, would be considered to be significant risks;
 - (c) The relationship between significant classes of transactions, account balances and disclosures and significant risks;
 - (d) Whether the definition should continue to make reference to “risks of material misstatement,” or whether this should be changed to refer to inherent risks;

¹² At the September 2016 IAASB and IAASB CAG meetings, the Task Force recommended the use of two filters, being “difficult for management to control” and “management does not or fails to control,” as being useful to the identification of significant risk. Feedback on the proposed two filters was that it wasn’t clear how the two filters would work together in practice without creating additional complexity, nor how the two filters would interrelate and work with the qualitative inherent risk factors. A number of IAASB members expressed the view that the second filter (management does not or fails to control) is delving into control risk and that would mean that significant risks would not be a subset of inherent risk completely. In considering this feedback, the Task Force was of the view that the proposed two filter process for the determination of significant risks would not have the intended effect of bringing clarity and consistency to the determination of significant risks, and therefore decided to no longer consider this approach.

- (e) How to operationalize the auditor's consideration of the qualitative inherent risk factors, and the relative likelihood and magnitude of the risk, when identifying significant risks; and
- (f) Further consider the addition of susceptibility to fraud as a qualitative inherent risk factor as it relates to aspects of both inherent risk and control risk.

Task Force Views

- 44. While the IAASB has previously agreed that the concept of significant risk be retained, recent Task Force discussions have included reflecting on the consequences and impediments of retaining the concept of significant risk in order to move forward in developing changes in ISA 315 (Revised). The purpose of these further reflections is to consider whether retaining the concept of significant risk consistent with the current direction will be of benefit, that is, will it enhance audit quality and also address the issues identified in paragraphs 26 and 43–45 in the Project Proposal.
- 45. A question that has been raised consistently both during IAASB discussions and within Task Force discussions is, regardless of the revised definition, what is it that an auditor will do differently to address significant risks in comparison to other risks of material misstatement, in particular other higher inherent risks that might not be concluded to be significant risks? Although most of the audit consequences to identifying significant risks are not within the scope of ISA 315 (Revised), the Task Force agrees that it is appropriate to validate that any revisions to the determination of significant risks in ISA 315 (Revised) will have appropriate and meaningful effects on the procedures to be performed related to these 'special' risks under other ISAs.
- 46. The following is a summary of the requirements in the ISAs where the concept of significant risks has consequences, and the Task Force views in relation to them assuming that the concept of significant risks is enhanced as previously described:
 - (a) Paragraph 29 of ISA 315 (Revised) requires the auditor to obtain an understanding of the entity's controls, including control activities, relevant to significant risks. Paragraph 15 of ISA 330 requires that, if the auditor plans to rely on controls over a significant risk, the auditor shall test those controls in the current period. In line with the IAASB discussions related to significant risks being inherently "difficult to control", the Task Force is of the view that it would be appropriate to retain these requirements.
 - (b) Paragraph 21 of ISA 330 requires the auditor to perform substantive procedures that are specifically responsive to the significant risk. With the implementation of a spectrum of inherent risk in ISA 315 (Revised) that links to paragraph 7 of ISA 330, the Task Force view is that all risks of material misstatement essentially should be subject to substantive procedures that are appropriately responsive. Furthermore, as noted in prior IAASB discussions, there often is not something unique that is performed for significant risks that would not have been performed if the risk had been not designated as "significant." This is a similar challenge to what the ISA 540 Task Force encountered regarding what specific additional procedures might be required for accounting estimates that give rise to significant risks. In those deliberations, the conclusion reached was that it was not so much about the type or nature of the procedure to be performed in response to a significant risk, but rather the extent and timing of the procedure, who performed the procedure, who reviewed the work performed and the persuasiveness of the evidence obtained.

- (c) Paragraph 21 of ISA 330 also requires that, when the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. The Task Force view is that more persuasive audit evidence should be obtained for significant risks – requiring tests of details may be one method to achieve that. However, this requirement likely needs further consideration, including in conjunction with ISA 540 as it relates to auditing accounting estimates that are significant risks and the effects of data analytics on the audit.
 - (d) Paragraph 8(c) of ISA 230 requires audit documentation specific to significant matters arising during the audit. A significant risk is specified to be a significant matter in paragraph A8. Paragraph 19 of ISA 220 requires the engagement partner to discuss significant matters with the engagement quality control reviewer. The Task Force views these requirements to be appropriate in relation to significant risks, but not at the expense of appropriate levels of documentation and review for other areas of higher risks of material misstatement.
 - (e) In the new and revised Auditor Reporting Standards, identification of significant risks resulted in:
 - (i) ISA 260 (Revised)¹³ requiring the auditor to communicate significant risks, identified by the auditor, to those charged with governance. The Task Force is of the view that this communication to those charged with governance should be beneficial to the quality of the discussions between the auditor and those charged with governance.
 - (ii) In accordance with paragraph 9 of ISA 701,¹⁴ the auditor is required to determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor is required to take into account (among other items) areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised). The Task Force view is that communication of significant risks within the auditor’s reports when determined to be key audit matters in accordance with ISA 701 is a recent consequence for significant risks that needs to be specifically considered. The Task Force will liaise on an ongoing basis with the IAASB’s Auditor Reporting Implementation Working Group to understand any feedback specific to the relationship between significant risks and key audit matters.
47. The Task Force has identified the following impediments should the concept of significant risk be retained in line with the current direction:
- (a) In the context of the proposed spectrum of inherent risks in ISA 315 (Revised), as previously discussed with the IAASB, significant risks will be those inherent risks that are at the highest end of the spectrum of inherent risks, effectively requiring a threshold that will need to be defined. The Task Force is of the view that defining that threshold will be challenging (consistent with the challenges the ISA 540 Task Force has had with defining lower risk in relation to the audit of accounting estimates and related disclosures).
 - (b) The Task Force is of the view that significant auditor judgment will continue to be required when identifying significant risks. This judgment will arise from the determination of the influences of the qualitative inherent risk factors and that a new definition is not going to remove the need for auditor judgment.

¹³ ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraphs 15 and A12–A13

¹⁴ ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*

- (c) By continuing to stress the importance of the identification of significant risks, this may continue to have unintended consequences for some audits, such that other risks of material misstatement do not receive an appropriate amount of auditor focus or attention.
 - (d) In revising the definition of significant risk, it may be difficult to revise the definition to adequately capture the appropriate consideration of fraud risks, i.e., will moving toward a more precise definition of significant risk result in the ability of the nature of fraud risks to be captured by that definition? The Task Force needs to further discuss and develop its thinking in this area but is of the view that capturing fraud risks in a revised definition will be challenging (e.g., are fraud risks higher in likelihood, particularly in all cases).
48. The Task Force is of the view that, in order to continue progressing the revised concept of significant risks, the consequences of the determination of significant risks for the audit (described in paragraph 46 or other consequences that the IAASB believes should be considered by the Task Force) need to be viewed by the IAASB as benefits and those benefits need to be viewed as being great enough to overcome the impediments (as outlined above or others that the IAASB may identify). The Task Force seeks further direction from the IAASB regarding the next steps that the Task Force should consider in progressing revisions to the concept of significant risk.
49. The Task Force has also continued to discuss significant risks since the IAASB's December 2016 meeting, but has not significantly progressed the majority of matters raised by the Board as the group focused predominantly on new matters for Board discussion on March 2017. However, the Task Force did agree on the following two matters for discussion with the IAASB in March 2017, including further consideration of retaining the concept of significant risk (as described above) and:
- (a) Whether inherent risks that have low relative likelihood of occurrence with high magnitude of impact should be identified as significant risks—the Task Force is proposing that these are not significant risks because it is only the highest inherent risks that would be considered as significant risks; and
 - (b) Proposed working definition of significant risk based on the IAASB direction to date—to assist with further discussions about significant risk by developing a working definition to facilitate consistent understanding of what significant risks are.

Matter for IAASB CAG Consideration

2. Representatives are asked to provide views on the Task Force proposals and IAASB decisions to date in relation to significant risks in paragraphs 42–49 above. In particular, the Task Force would like to understand Representatives' views on retaining the concept of significant risk.

Section III – The Auditor's Understanding of Internal Control

Background

50. Paragraph 12 of ISA 315 (Revised) requires the auditor to obtain an understanding of internal control relevant to the audit. Paragraphs 14–24 of ISA 315 (Revised) address the extent to which the auditor should obtain an understanding of each component of internal control.

51. ISA 315 (Revised) identifies five components of internal control as follows:¹⁵
- (a) The control environment;
 - (b) The entity's risk assessment process;
 - (c) The information system, including the related business processes, relevant to financial reporting (referred to herein as information system relevant to financial reporting), and communication;
 - (d) Control activities relevant to the audit; and
 - (e) Monitoring of controls.
52. Several of the matters noted in the ISA 315 (Revised) Project Proposal and the ISA Post-Implementation Monitoring project related to challenges experienced by auditors in particular relating to the extent of understanding of internal control relevant to the audit that is necessary.

The Purpose of the Auditor Obtaining an Understanding of Internal Control

53. Although there is overall support for Task Force efforts to clarify the purpose of the auditor obtaining an understanding of internal control, the feedback on the Task Force's initial view that an additional purpose of obtaining an understanding of internal control was to inform the auditor's inherent risk assessment was mixed.
54. The IAASB agreed that obtaining an understanding of internal control may assist the auditor in identifying inherent risks (because the nature and extent of the controls implemented may highlight risks that the auditor had not otherwise identified) but did not agree that this should be addressed by further clarifying the purpose for obtaining an understanding of internal control in the standard. Board members commented that clarifying the purpose in this manner could imply that the auditor always needed to understand controls for this purpose, whereas this should be a matter of judgment in the circumstances. Representatives have cautioned the Task Force of the risk of blurring the lines between inherent risk and control risk when explaining these matters.

Task Force Views—The Purpose of the Auditor Obtaining an Understanding of Internal Control

55. The Task Force took into account the feedback to its initial proposals to clarify the purpose of the auditor obtaining an understanding of internal control and further explored the relationship of the auditor's understanding of internal control to the auditor's identification and assessment of the risks of material misstatement.
56. Paragraph 6(b) of ISA 210¹⁶ states that "the auditor shall obtain the agreement of management that it acknowledges and understands its responsibility:
- (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
 - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error....."

This highlights the importance of internal control in the context of an audit because the ISAs establish that

¹⁵ ISA 315 (Revised), paragraphs 14–24 and A59

¹⁶ ISA 210, *Agreeing the Terms of Audit Engagements*

management acknowledges and understands its responsibility for internal control as a pre-condition to acceptance of an audit.

57. The Task Force notes that paragraph 12 of ISA 315 (Revised) states that (see Table 1 for full wording of paragraph 12):

“The auditor shall obtain an understanding of internal control relevant to the audit. ... It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit”.

Paragraph A50 (supporting application material to paragraph 12) further explains that:

“An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.”

58. The Task Force is of the view that paragraphs 12 and A50 of ISA 315 (Revised) provide the overarching framework for the auditor’s understanding of internal control relevant to the audit and from this understanding, the auditor may identify factors that affect inherent risk or control risk. That is, the understanding of internal control provides insights into the risks that management is controlling, as well as information about how management controls them. This understanding is therefore foundational to the auditor’s ability to identify the risks of material misstatement in the financial statements.
59. Further, “controls relevant to the audit” has been raised as a concept in need of clarification, particularly as it relates to how the auditor determines the control activities relevant to the audit (discussed further below). The Task Force view is that, building from the principle in paragraph A50 of ISA 315 (Revised), “controls relevant to audit” consist of essentially those controls that the auditor needs to understand in order to facilitate the auditor’s identification of the risks of material misstatement in the financial statements.

Task Force Recommendations

60. The Task Force recommended that a number of clarifications be made in ISA 315 (Revised) related to the purpose of the auditor obtaining an understanding of internal control. These clarifications can be summarized as follows:
- (a) The risk assessment process required by ISA 315 (Revised) involves both the identification and assessment of risks of material misstatement (by identifying inherent risks and control risks separately and then assessing the risks either separately or simultaneously). Obtaining an understanding of the FRF, the entity and its environment, and internal control are all necessary inputs to the auditor’s identification of risks of material misstatement.
 - (b) Paragraph 12 of extant ISA 315 (Revised) provides the overarching framework for the auditor’s understanding of internal control relevant to the audit and that from the understanding of internal control, the auditor may identify factors that affect inherent risk or control risk.
 - (c) While the auditor may make separate or simultaneous assessments of inherent risk and control risk,¹⁷ it is the assessment of inherent risk that is most important in understanding the work that needs to be performed to respond to identified risk. As explained in paragraph 34 of this

¹⁷ ISA 200, paragraph A40

paper, the auditor's understanding of inherent risk informs the identification of significant risks and other risks for which the auditor may determine (based on the auditor's judgement) obtaining an understanding of control activities may be necessary. By understanding the relative placement of inherent risks on the spectrum, the auditor is able to make better informed decisions about the further audit procedures to be performed.

Internal Control Relevant to the Audit

Components of Internal Control

61. Feedback to date has noted support for the Task Force continuing to explore scalability in the requirements for the auditor to obtain an understanding of internal control. At the September 2016 IAASB and IAASB CAG meetings, the Task Force explored the relevance of the components of internal control to the audit, suggesting that all five components¹⁸ of internal control may not be relevant to the audit in all cases.

Components of Internal Control—Task Force Recommendations

62. The IAASB expressed the view that the significant challenges that need to be addressed within this area are the:
- (a) Implicit reliance on controls (i.e., reliance on controls by the auditor without appropriate evaluation of those controls), more specifically higher-level controls, by some small- and medium-sized practitioners (SMPs and auditors of small- and medium-sized entities (SMEs); and
 - (b) Fact that auditors that have determined to take a primarily substantive approach to the audit do not see the value of obtaining an understanding of internal control, and therefore view the requirement in ISA 315 (Revised) to obtain an understanding of internal control as unnecessary and as a compliance exercise.
63. The IAASB will discuss the matter noted in paragraph 62(b) above at its March 2017 meeting.

Clarification of Requirement to Obtain an Understanding of Internal Control Relevant to the Audit

64. Feedback from the September 2016 meetings indicated support for the Task Force view that it is important for there to be a clear link between the overarching requirement to understand internal control relevant to the audit in paragraph 12 of ISA 315 (Revised), and the requirements related to the auditor obtaining that understanding for each of the individual components of internal control relevant to the audit (paragraphs 14 to 24 of ISA 315 (Revised)) (where they exist). The IAASB also supported the Task Force's recommendation to clarify what is meant by the phrase "relevant to the audit" within ISA 315 (Revised). See above for further discussion of Task Force views and recommendations regarding the relevance of each of the components of internal control relevant to the audit.

¹⁸ (i) Control environment; (ii) the entity's risk assessment process; (iii) the information system, including the related business processes, relevant to financial reporting, and communication; (iv) control activities relevant to the audit and (v) monitoring of controls.

Task Force Recommendations and Related IAASB Feedback—Clarification of Requirement to Obtain an Understanding of Internal Control Relevant to the Audit

Table 1. Obtaining an Understanding of Internal Control Relevant to the Audit
<p>ISA 315 (Revised) – Extant</p> <p>12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A50–A73)</p>
<p>Task Force Recommendations</p> <p>To address the feedback regarding the need for a closer link between paragraph 12 and paragraphs 14–24, the Task Force recommends the following revisions to paragraph 12 of ISA 315 (Revised):</p> <p>12. The auditor shall obtain an understanding of internal control relevant to the audit <u>through obtaining an understanding of the components of internal control in accordance with paragraphs 14 to 24 of this ISA</u>. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A50–A73)</p> <p>The Task Force is of the view that the suggested insertion to the requirement, along with additional application material, will clarify that:</p> <ul style="list-style-type: none">• The requirements in paragraphs 14 to 24 of ISA 315 (Revised) inform the auditor how to meet the requirement in paragraph 12 of ISA 315 (Revised) to obtain an understanding of internal control relevant to the audit; and• The auditor may not bypass the requirements in paragraphs 14–24 of ISA 315 (Revised) because they have made an initial assessment that primarily a substantive approach to the audit will be taken and that no controls are relevant to the audit.

Nature and Extent of the Understanding of Relevant Controls

65. Auditors of entities of all sizes have noted that the requirement to evaluate the design of controls and determine whether they have been implemented¹⁹ is not clear (i.e., when the design of controls is required to be evaluated and the nature and extent of the work effort to do this).
66. As part of this project, the IAASB agreed that the Task Force should explore revisions to ISA 315 (Revised) to clarify the differing nature and extent of work required by the auditor when:
- (a) Obtaining the required understanding of the components of internal control (in accordance with paragraph 12 of ISA 315 (Revised));

¹⁹ ISA 315 (Revised), paragraph 13

- (b) Evaluating the design of those controls relevant to the audit and determining whether they have been implemented (in accordance with paragraph 13 of ISA 315 (Revised)); and
- (c) Designing and performing tests of controls to obtain sufficient appropriate evidence as to the operating effectiveness of those controls relevant to the audit (in accordance with paragraph 8 of ISA 330).

The differentiation of the nature and extent of work required by the auditor in meeting the requirements referred to above is often more apparent with respect to controls within the control activities component of internal control, but not as apparent for controls within the other four components of internal control.

Task Force Recommendations—Nature and Extent of the Understanding of Relevant Controls

- 67. Through feedback received from the ISA Implementation Monitoring Project, Task Force member experiences and information gathered from outreach performed by the Task Force, the challenges regarding design and implementation of controls are viewed to be related to controls within the components of: the control environment; the entity's risk assessment process; information systems and communication; and monitoring of controls. With respect to controls within the control activities component, challenges are generally related to which of those controls are relevant to the audit, and less with the design and implementation of those controls.
- 68. For design and implementation of controls within the control environment, the entity's risk assessment process, information systems and communication and monitoring of controls, the Task Force is still considering whether the requirements in the relevant paragraphs in ISA 315 (Revised) (being paragraphs 14–19 and 22–24, and the related application material) already provide the requirements that the auditor needs to meet in order to evaluate the design of controls within those components and determine whether they have been implemented in accordance with paragraph 13 of ISA 315 (Revised).
- 69. Similar to the Task Force' views related to the challenges with paragraph 12 of ISA 315 (Revised), the Task Force is of the view that creating a clearer link between the requirement in paragraph 13 of ISA 315 (Revised) and the requirements in paragraphs 14–19 and 22–24 (and related application material) in ISA 315 (Revised) would clarify for auditors how the requirement in paragraph 13 of the standard is met. In addition, the Task Force intends to analyze the application material in extant ISA 315 (Revised) related to paragraphs 14–24 of the standard and determine how the existing guidance applies to obtaining an understanding of the component (and the respective controls within it) or evaluating the design of those controls and whether they have been implemented, and assess whether additional guidance is needed to address any gaps. Refer to Table 2 for further discussion on the Task Force's exploration of this area.

Table 2. Nature and Extent of the Understanding
ISA 315 (Revised) – Extant
13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A73–A75)
Task Force Recommendations
Without yet making suggestions for possible wording changes to, or the development of guidance related to the application of, paragraph 13 of ISA 315 (Revised), the Task Force recommends possible revisions to be made to:
<ul style="list-style-type: none">• Create a link between the overarching requirement in paragraph 13 of ISA 315 (Revised) for the auditor to evaluate the design of the controls relevant to the audit and determine whether they have been implemented and the requirements in paragraphs 14–24 of ISA 315 (Revised) which include requirements and related application material that help the auditor determine how to meet paragraph 13 of the standard;• In addition to the analysis referenced in paragraph 69 of this paper, clarify that testing the operating effectiveness of controls is different from obtaining an understanding of the control, evaluating the design of the control and determining if the control has been implemented; and• Clarify that the requirement related to the design and implementation of controls is only in respect of controls relevant to the audit.

70. The IAASB is supportive of the Task Force proceeding with the recommendations in Table 2 above. The Task Force intends to discuss further considerations related to its recommended possible changes above commencing with a discussion about how controls within each component are “relevant to the audit,” which has been noted as most challenging for auditors. The Task Force has started exploring ways to provide further clarification of what is meant by “controls relevant to the audit” for each of the five components of internal control, with planned discussions about ‘control activities relevant to the audit’ planned for March 2017 and the other four components of internal control at a later IAASB and IAASB CAG meeting.

IAASB Views on Matters Related to Internal Controls

71. The Task Force has discussed matters relating to internal control with the IAASB at its September and December 2016 meetings. To date, those discussions have resulted in the IAASB agreeing to the following related to internal controls:
- (a) The Board agreed that the existing audit risk model is still appropriate and should be retained.
 - (b) The Board had mixed views on whether an additional purpose of obtaining an understanding of internal control informs the auditor's assessment of inherent risk, as well as the auditor's assessment of control risk. Board members noted that stating that obtaining an understanding of controls informed inherent risk would create confusion without really assisting auditors with the identification of risks of material misstatement. The purpose of obtaining an understanding of internal control is already well set out in paragraph 20 of ISA 315 (Revised), and suggested

making it clearer that the auditor may be able to learn more about the inherent risk from what and how the entity has attempted to control those inherent risks.

- (c) The significant challenges that need to be addressed within this area are (a) the implicit reliance on controls (i.e., reliance on controls by the auditor without appropriate evaluation of those controls), more specifically higher-level controls, by some SMPs and auditors of SMEs; and (b) the fact that auditors that have determined to take a primarily substantive approach to the audit do not see the value of obtaining an understanding of internal control, and therefore view the requirement in ISA 315 (Revised) to obtain an understanding of internal control as unnecessary and as a compliance exercise.
 - (d) It is important for there to be a clear link between the overarching requirement to understand internal control in paragraph 12 of ISA 315 (Revised), and the requirements related to understanding each of the individual components of internal control (paragraphs 14–24 of ISA 315 (Revised)).
 - (e) The five components of internal control are interlinked and therefore were generally not supportive of suggesting that some of the components are always relevant to an audit, while other components may not always be relevant to the audit.
 - (f) The components of internal control should be kept ‘wrapped’ together, to make it clear in ISA 315 (Revised) that in an audit of an SME, the auditor could obtain an understanding of internal control relatively quickly whereas in a larger entity the auditor would need to do more to obtain the appropriate understanding.
72. The Board supported the Task Force’s efforts in further considering how the auditor’s identification and assessment of internal controls could be made more scalable, and encouraged the Task Force to keep progressing in this regard.

Matter for IAASB CAG Consideration

3. Representatives are asked to provide views on the Task Force proposals and IAASB decisions to date in **Section III** above. In particular, the Task Force is interested in Representatives views on:
- (a) The purpose of the auditor obtaining an understanding of internal control.
 - (b) Understanding internal control *relevant to the audit*.
 - (c) The nature and extent of the understanding of internal controls required.

Section IV – Other Topics to be discussed at the March 2017 IAASB Meeting (for IAASB CAG Information Purposes Only)

73. Task Force discussion and views on other topics to be discussed with the IAASB at the March 2017 IAASB meeting include:
- (a) *Information Technology*—the extent of the auditor’s understanding of Information Technology (IT) in obtaining the required understanding of the entity and its environment and internal control.
 - (b) *Data Analytics*—With input from the IAASB’s Data Analytics Working Group (DAWG), exploring how the use of technology, specifically data analytics, is able to support the auditor’s risk

assessment procedures, including initial discussions on how data analytics could best be incorporated into ISA 315 (Revised).

- (c) *Professional Skepticism*—Building off of the Professional Skepticism Working Group’s (PSWG) discussions with the IAASB at the June, September and December 2016 IAASB meetings, initial Task Force considerations of possible enhancements to ISA 315 (Revised) to enhance the exercise of professional skepticism in performing risk assessment procedures during the audit.

Section V – Other Matters (for IAASB CAG Information Purposes Only)

Link to Acceptance and Continuance of Audit Engagements

- 74. The Task Force discussed the need to respond to feedback received in response to the December 2015 Invitation to Comment, *Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*, which referred to the need to strengthen the link between ISA 220²⁰ related to identifying and assessing quality risks and putting in place the appropriate responses to address those risks and the identification of risks arising from the client continuance and acceptance procedures.

Task Force Views – Information Obtained in the Acceptance or Continuance Process

- 75. The Task Force discussed the requirement in paragraph 7 of ISA 315 (Revised) regarding the auditor’s consideration of information obtained from the auditor’s client acceptance or continuance process in identifying risks of material misstatement. The Task Force was of the view that the requirement should be made stronger, as:
 - (a) Information gathered during the client acceptance and continuance process would be expected to include information about risks that are relevant to the auditor’s risk assessment, and therefore should be considered by the auditor; and
 - (b) There is inconsistency in practice in using information obtained during the client acceptance or continuance process in the identification of risks of material misstatement.

Task Force Recommendations

- 76. The Task Force recommends the following revision to paragraph 7 of ISA 315 (Revised):

In identifying risks of material misstatement, the auditor shall consider whether information obtained from the auditor’s client acceptance or continuance process is relevant to identifying risks of material misstatement.
- 77. The Task Force recommends the development of application material to explain why information that is obtained during the acceptance or continuance process is relevant to the identification of risks of material misstatement.
- 78. The Task Force will coordinate with the ISA 220 (Crossover) Working Group in further considering changes to this aspect.

²⁰ ISA 220, *Quality Control for an Audit of Financial Statements*

Extracts of relevant PCAOB references noted throughout the paper

PCAOB AS 12

Identifying and Assessing the Risks of Material Misstatement

59. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should:

...

- e. Identify significant accounts and disclosures³³ and their relevant assertions³⁴ (paragraphs 60–64 of this standard).

Note: The determination of whether an account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

...

³³ Paragraph A10 of Auditing Standard No. 5 states:

“An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.”

³⁴ Paragraph A9 of Auditing Standard No. 5 states:

“A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.”

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

60. To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 59.e., the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account and disclosure characteristics.”