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**Exposure Draft ED-315 *ISA 315 Identifying and Assessing the  
Risks of Material Misstatement***

**31 October 2018**

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The Chair  
International Auditing and Assurance Board  
C/- The International Federation of Accountants  
529 5<sup>th</sup> Avenue  
New York New York  
United States of America

Dear Sir

**Re: Exposure Draft ED-315 *ISA 315 Identifying and Assessing the Risks of Material Misstatement***

On behalf of the Institute of Public Accountants (IPA), I submit our review of Exposure Draft ED-315 *ISA 315 Identifying and Assessing the Risks of Material Misstatement*.

While the IPA welcomes the move to modernise ISA 315, the IPA is concerned the modifications proposed in the ED will not be an answer to the poor application of the existing standard by auditors.

The IPA, in particular, has the following concerns:

1. Substantive testing bias – The IPA is of the view that the application of ISA 315 by auditors has been affected by a bias in auditing towards substantive procedures. Many auditors are reluctant to allocate scarce audit fees to documenting and understanding the system of internal control. As it is not appropriate to rely solely on tests of controls (ToCs), auditors often believe it is more efficient not undertake such audit procedures. This tendency is reinforced by the risk that if controls-based approach is adopted and the ToCs indicate the controls are not reliable, the auditor will have to undertake the same level of substantive testing as they would have if they had not undertaken the controls-based approach.
2. Insufficient emphasis on understanding transactions – while the standard emphasises the need to understand the system of internal control, the need to understand how transactions are recorded in the general ledger and financial statements is not given the same emphasis. The IPA believes the current inclination by auditors to adopt a substantive audit approach and not rely on controls has reduced auditors understanding transaction flows, i.e. if controls are not relied upon transaction flows are not required to be understood and documented.
3. ISA 315 should be “re-balanced” so that the auditor has a primary obligation to understand the transaction flows of the client and document them. The requirement to identify controls should be a bi-product of this process. The guidance should also indicate that adjustments and balances outside the transaction systems should have higher inherent risk due to possibility of management override and bias.

4. Inter-relationship of inherent and control risk – the proposed amendments to ISA 315 do not provide any indication as to the relationship between the control environment and inherent risk. There is a view that inherent risk is mitigated by a strong control environment, however a weak control environment cannot increase inherent risk (i.e. a high inherent risk can't be made worse by a poor control environment). An alternative view is that inherent and control risks are additive. ISA 315 is not clear on this relationship. In any event, it is arguable that certain aspects of inherent risk could be categorised as control environment elements e.g. governance structure, management experience, and propensity for misstatement. The IPA believes further guidance should be given in relation to such factors.
5. Nature of inherent risk – the IPA believes the consideration of inherent risk is not fully developed in ISA 315 and further guidance is needed. The IPA also of the view that the guidance on inherent risk should directly address facts that indicate a “motive to misstate”. This is addressed to some extent in ISA 315.A5, but it warrants further discussion including the effects of remuneration arrangements on the motive to misstate. The IPA is concerned that auditors do not give sufficient weight to the pervasive nature of the motive to misstate when assessing risk.
6. Inherent risk and fraud – the IPA is of the view that ISA 240 should reflect more clearly the motive to misstate arising from inherent risk factors when assessing fraud. Fraud is often narrowly considered by auditors to relate to misappropriation of assets with other types of fraud not given enough emphasis. The motive to misstate arising from the need to meet performance targets (either in terms of market expectations or in relation to performance related remuneration arrangements) should be more clearly articulated in ISA 240; together with the identification of the relevant inherent risk factors that give rise to such a risk. Similarly, the risk of regulatory fraud (i.e. the non-reporting of contraventions with regulation) should have more emphasis in ISA 240.
7. Risk response –It is unfortunate that the IAASB did not address ISA 330 when revising ISA 315 as the two standards are highly interrelated. The IPA is particularly concerned that auditors often display limited responses to increased risk i.e. a decrease in materiality and/or an increase sample size. The materiality response is particularly a concern as in isolation (unless coupled with a sampling methodology) has no direct effect on the nature and extent of audit procedures.
8. Risk spectrum – The IPA has deep concern with the introduction of risk spectrum approach. The IPA is of the view that auditors already display a propensity to underestimate risk and that this would be exacerbated by a spectrum approach to risk. The IPA also believes that a risk spectrum approach is inappropriate in an audit context as a risk spectrum implies a granular response to risk mitigation (e.g. increased risk capital allocated to increasing credit risk) that is not demonstrated in the audit response to risk which is a “step” approach. As such, the IPA recommends that the standard recognise that three or four discrete risk grades (e.g. High, Moderate, Low) may result from the risk assessment process rather than use the term “risk spectrum”.

9. Overall audit plan –Many audit files lack a detailed overall audit planning document. Often the checklist and form-based approach adopted for audit planning results in a number of documents that purport to meet the requirements of ISA 315, but rarely are such documents distilled into an overall plan that can concisely set forth the issues required to be addressed by ISA 315 and ISA 330. As such the ability to communicate the pertinent aspects of the audit to the engagement team is compromised. The IPA is disappointed that IAASB, with the revision ISA 315, did take the opportunity to stress the importance of the overall audit planning document.

Our comments and responses to the questions in the Exposure Draft are set out in the Appendix to this letter.

If you would like to discuss our comments, please contact me or our technical advisers Mr Stephen La Greca ([stephenlagreca@aol.com](mailto:stephenlagreca@aol.com)) or Mr Colin Parker ([colin@gaap.com.au](mailto:colin@gaap.com.au)) (a former member of the AASB), GAAP Consulting.

Yours sincerely

Vicki Stylianou  
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CC Chair, AUASB

### **About the IPA**

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 35,000 members in Australia and in over 65 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. Through representation on special interest groups, the IPA ensures the views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Tax Office (ATO), Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) on issues affecting our members, the profession and the public interest. The IPA recently merged with the Institute of Financial Accountants of the UK, making the new IPA Group the largest accounting body in the SMP/SME sector in the world.

## **Appendix Overall Questions**

### **Question 1**

*Has ED-315 been appropriately restructured, clarified and modernised in order to promote a more consistent and robust process for the identification and assessment of the risks of material misstatement. In particular:*

- (a) Do the proposed changes help with the understandability of the risk identification and assessment process? Are the flowcharts helpful in understanding the flow of the standard (i.e., how the requirements interact and how they are iterative in nature)?*
- (b) Will the revisions promote a more robust process for the identification and assessment of the risks of material misstatement and do they appropriately address the public interest issues outlined in paragraphs 6-28?*
- (c) Are the new introductory paragraphs helpful?*

### **IPA response**

- (a) While the proposed changes to ISA 315 are improvements to the existing standard, the IPA has a number of concerns:
  - i. While the IPA supports the separate consideration of inherent and control risk, the guidance provided in this area is relatively light given the importance of the assessment on the overall audit approach
  - ii. The overlap/interrelationship of inherent risk and control environment considerations is not adequately addressed
  - iii. There is insufficient emphasis of knowledge of the business and the environment in which it operates
  - iv. While there is extensive information provided in understanding the client's system of internal control, not the same emphasis is given to understanding the client's transaction systems
  - v. The IPA supports the inclusion of the flowcharts in ISA 315 but notes the status of the flowcharts is unclear. Do they represent application guidance and if so how are they to be presented in the final standard?
- (b) While the IPA believes the proposed revisions are generally an improvement, in our response to other questions the IPA has concerns with the detail of some of the changes and believes the guidance is insufficient to address deep-seated deficiencies in auditor's assessment and response to risk.
- (c) The IPA supports the inclusion of introductory paragraphs in the proposal, however the introductory paragraphs should be extended to include the importance of documenting the auditor's understanding of the client's business and systems, and the need to obtain sufficient appropriate audit evidence when undertaking the risk assessment.

## **Question 2**

*Are the requirements and application material of ED-315 sufficiently scalable, including the ability to apply ED-315 to the audits of entities with a wide range of sizes, complexities and circumstances?*

### **IPA response**

Other than the intrinsic scalability relating to complexity and scale of the client's operations, ISA 315 is not otherwise scalable. The limited guidance included in the standard is of some use, but does not address the primary issue that smaller engagements are often fee constrained and this constraint coupled with the overall under appreciation of the importance of audit planning process (including knowledge of the client's system and processes) often results in smaller engagements concentrating on "doing the audit" rather than planning.

In addition, the IPA disagrees with the ISA 315.A224 statement that smaller entities may have a greater proportion of assessed inherent risks at the lower end of the spectrum. The IPA is of the view that many instances of audit failure in relation to smaller entities can be directly attributable to such assumptions ignoring the impact on inherent risk of dominance of management (even owner managers), the limitation of funding sources and the lack of internal controls, management experience and oversight. The IPA strongly recommends this paragraph be deleted.

## **Question 3**

*Do respondents agree with the approach taken to enhancing ED-315 in relation to automated tools and techniques, including data analytics, through the use of examples to illustrate how these are used in an audit (see Appendix 1 for references to the relevant paragraphs of ED-315)? Are there other areas within ED-315 where further guidance is needed in relation to automated tools and techniques, and what is the nature of the necessary guidance?*

### **IPA response**

The IPA disagrees with the approach to "data analytics". It fails to consider what audit procedures are required to be undertaken to place reliance on the data that is being used by such data analytical procedures. Such procedures are required to determine the validity of the data being analysed and will take a combination of test of controls on the underlying data transaction streams and tests of applicable general controls. The IPA also notes the approach to data analytics is inconsistent with the process required by ISA 520 which requires the consideration of the reliability of data and indicates testing operating effectiveness of controls relating to data subject to analytical review procedures.

Furthermore, ISA 315 (or another standard) needs to address the use of "big data" or "meta-data" arising from client data warehouses where the data has been sourced from systems (internal or external) that are not subject to internal controls often applied to financial reporting systems.

Finally, the IPA is concerned the example in ISA 315.A15 stating that analytical procedures performed using data analytics during the risk assessment process can be used to provide substantive audit evidence. This example implies that no audit procedures are required to ensure the validity of data used in such procedures.

#### **Question 4**

*Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk identification and assessment process? Do you support the proposed change for the auditor to obtain ‘sufficient appropriate audit evidence’ through the performance of risk assessment procedures to provide the basis for the identification and assessment of the risks of material misstatement, and do you believe this clarification will further encourage professional scepticism?*

#### **IPA response**

The IPA is of the view that while some additional material in relation to professional scepticism is helpful, that in assessing inherent risk the auditor needs to determine factors giving rise to a “motive to misstate”. The existence of such a motive should link to both inherent risk and professional scepticism.

The IPA supports the requirement to obtain sufficient appropriate audit evidence to support risk assessment. The IPA notes that the planning sections of audit file are often based on questionnaire and form-completion based largely on management representation, and as such the IPA welcomes the clarification that sufficient appropriate audit evidence needs to be obtained to facilitate risk assessment and response.

#### **Question 5**

*Do the proposals made relating to the auditor’s understanding of the entity’s system of internal control assist with understanding the nature and extent of the work effort required and the relationship of the work effort to the identification and assessment of the risks or material misstatement? Specifically:*

- (a) Have the requirements related to the auditor’s understanding of each component of the entity’s system of internal control been appropriately enhanced and clarified? Is it clear why the understanding is obtained and how this informs the risk identification and assessment process?*
- (b) Have the requirements related to the auditor’s identification of controls relevant to the audit have been appropriately enhanced and clarified? Is it clear how controls relevant to the audit are identified, particularly for audits of smaller and less complex entities?*
- (c) Do you support the introduction of the new IT-related concepts and definitions? Are the enhanced requirements and application material related to the auditor’s understanding of the IT environment, the identification of the risks arising from IT and the identification of general IT controls sufficient to support the auditor’s consideration of the effects of the entity’s use of IT on the identification and assessment of the risks of material misstatement?*

#### **IPA response**

ISA 315 should give primacy to the understanding the client’s system for recording transactions and that the assessment of controls should be a by-product of obtaining such an understanding.

- (a) & (b) As noted in our covering letter, the IPA remains concerned that the proposed changes to ISA 315 do not address the auditors' propensity to defer to a substantive audit approach and only assess control (if at all) at the most superficial level.
- (c) The IPA supports the changes to ISA 315 relating to IT concepts and definitions and the related guidance. However, the IPA believes ISA 315 should address the implications of cloud-based services and particularly "software as a service" as they impact general controls and the need or otherwise to obtain ISAE 3402 reports.

### **Question 6**

*Will the proposed enhanced framework for the identification and assessment of the risks of material misstatement result in a more robust risk assessment? Specifically:*

- (a) Do you support separate assessments of inherent and control risk at the assertion level, and are the revised requirements and guidance appropriate to support the separate assessments'?*
- (b) Do you support the introduction of the concepts and definitions of inherent risk factors to help identify risks of material misstatement and assess inherent risk? Is there sufficient guidance to explain how these risk factors are used in the auditor's risk assessment process?*
- (c) In your view, will the introduction of the 'spectrum of inherent risk' (and the related concepts of assessing the likelihood of occurrence, and magnitude, of a possible misstatement) assist in achieving greater consistency in the identification and assessment of the risks of material misstatement, including significant risks?*
- (d) Do you support the introduction of the new concepts and related definitions of significant classes of transactions, account balances and disclosures, and their relevant assertions? Is there sufficient guidance to explain how they are determined (i.e., an assertion is relevant when there is a reasonable possibility of occurrence of a misstatement that is material with respect to that assertion), and how they assist the auditor in identifying where risks of material misstatement exist?*
- (e) Do you support the revised definition, and related material, on the determination of 'significant risks'? What are your views on the matters presented in paragraph 57 of the Explanatory Memorandum relating to how significant risks are determined on the spectrum of inherent risk?*

### **IPA response**

- (a) While the IPA supports the separation of the assessment of inherent and control risk, we believe further guidance is required, including guidance on the interrelationship between inherent and control risk and inherent risk factors. The IPA is also of the view that when considering inherent risk, the recognition of factors contributing to a "motive to misstate" should be given greater prominence.
- (b) The IPA believes further guidance is required on inherent risk explicit recognition of the factors that contribute to a "motive to misstate".
- (c) The IPA has concerns with the concept of a "spectrum of inherent risk" in the context of audit. A spectrum of risk implies a graduated scale of risk and a level of precision

and granularity not evident in most audit risk processes. Furthermore, audit risk response is not graduated but rather represents discrete responses. Audit risk is most often considered as discrete level e.g. high, medium and low and the audit response is calibrated to those discrete levels. Many audit procedures do not have the characteristics to respond to the level of granularity.

- (d) The IPA supports the concept of identifying significant classes of transactions, account balances and disclosures. The distinction between significant transactions, accounts and disclosures and material transactions, accounts and disclosures and the appropriate audit response (while set out in both ISA 315 and ISA 330), needs to be presented in summary format. Although the flowcharts are useful, the IPA recommends a tabular format of nature of the items and the audit response should be included in ISA 330. In addition, the IPA is concerned with one of the examples of significant disclosures at ISA 315.A214 where it is stated that a significant disclosure would be liquidity and debt covenants of entity in financial distress. The IPA's concern is the example implies that such disclosures are significant at the time of financial distress when in fact they may be relevant when the entity has little margin before breach of the covenants is possible even though the entity may technically have no going concern issues at reporting date.
- (e) Subject to IPA's concern with the term "spectrum of risk", the IPA believes it would be useful to include material similar to that in paragraph 57 of the Explanatory Memorandum in the application guidance to the standard.

#### **Question 7**

*Do you support the additional guidance in relation to the auditor's assessment of risks of material misstatement at the financial statement level, including the determination about how, and the degree to which, such risks may affect the assessment of risks at the assertion level?*

#### **IPA response**

The IPA support the additional guidance in relation to the auditor's assessment of risk of material misstatement at the financial statement level.

#### **Question 8**

*What are your views about the proposed stand-back requirement in paragraph 52 of ED-315 and the proposed revisions made to paragraph 18 of ISA 330 and its supporting application material? Should either or both requirements be retained? Why or why not?*

#### **IPA response**

While the IPA supports the proposed revision of ISA 330.18, the IPA remains unconvinced that the proposed "stand-back" requirements of ISA 315.52 are necessary. At the time of planning, it is unlikely that new information would be available to alter the original determination (which should occur at the completion of the risk assessment process). Furthermore, given the existing iterative nature of audit risk assessment, the IPA does not see the need for a distinct requirement in ISA 315 in relation to material but not significant transactions, account balances or disclosures. If necessary the requirement to reassess audit risk in light of audit evidence could specifically mention them.

## **Conforming and Consequential Amendments**

### **Question 9**

*With respect to the proposed conforming and consequential amendments to:*

- (a) ISA 200 and ISA 240 are these appropriate to reflect the corresponding changes made in proposed ISA 315?*
- (b) ISA 330, are the changes appropriate in light of the enhancements that have been made in proposed ISA 315 (Revised), in particular as a consequence of the introduction of the concept of general IT controls relevant to the audit?*
- (c) The other ISAs as presented in Appendix 2, these appropriate and complete?*
- (d) ISA 540 (Revised) and related conforming amendments (as presented in the Supplement to this exposure draft) are these appropriate and complete?*

### **IPA response**

- (a) Subject to the comments in the covering letter in relation to ISA 240, the IPA supports the proposed consequential amendments to ISA 200 and ISA 240.
- (b) The IPA supports the proposed consequential amendments to ISA 315.
- (c) The IPA supports the proposed consequential amendments in Appendix 2 of the Explanatory Memorandum.
- (d) While the IPA supports the consequential amendments to ISA 540, the IPA recommends that further amendments are needed. The IPA does not believe management bias is properly dealt with in ISA 540. The focus is on evidence of management bias in the determination of accounting estimates, in particular, the selection of assumptions. The IPA is of the view the standard should acknowledge that inherent risk related to a motive to misstate by management arising from factors such as remuneration arrangements and other KPIs. The IPA believes such inherent risk should impact the nature, extent and timing of audit procedures carried out in relation to accounting estimates and the current structure of ISA 540 does acknowledge such considerations.

### **Question 10**

*Do you support the proposed revisions to paragraph 18 of ISA 330 to apply to classes of transactions, account balances or disclosures that are 'quantitatively or qualitatively material' to align with the scope of the proposed stand-back in ED-315?*

### **IPA response**

In accordance with our response to Question 8, the IPA supports the proposed amendments to ISA 330.18 but is unconvinced of the usefulness of the proposed stand-back provisions of ISA 315.

## Requests for General Comments

### Question 11

*In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:*

- (a) Translations – recognising that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents not in reviewing the ED-315.*
- (b) Effective Date – recognising that ED-315 is a substantive revision and given the need for national due process and translation, as applicable, the IAASB believes that an effective date for the standard would for financial reporting periods beginning at least 18 months after approval of a final IAS. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide sufficient period to support effective implementation of the ISA.*

### IPA response

- (a) Not applicable.
- (b) While there are some substantial changes to ISA 315 proposed, the IPA does believe these changes represent a fundamental change in audit approach and would suggest that an operative date for financial periods commencing 18 months after the issue of the revised standard is ample time to implement the changes.

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## Executive summary