



Chairman

Via e-mail

Mr Arnold Schilder
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International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th Floor
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Exposure Draft: Proposed International Standard on Auditing 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*

Dear Mr Schilder

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the International Auditing and Assurance Standards Board's July 2018 Exposure Draft of the proposed International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement* (ED-315).

The Committee sets out below its views on key aspects of ED-315 that could be enhanced to further improve audit quality. Answers to selected questions in Section 4 "Request for Comments" are provided in the annex to this letter.

In March 2013, the Committee set out its key objectives for the reform of ISAs in a letter to the IAASB chair.¹ Broadly, the Committee believed that the standards then extant did not sufficiently address several significant issues faced by bank auditors, including certain issues identified in ISA 315. The following reiterates key aspects of our expectations:

- Banks operate in an environment where there is extensive regulation of their activities. They may have a variety of business models. To exercise professional skepticism and review the risks to banks independently, rather than only through the eyes of management, it is important for the auditor to understand banks' business models, the regulatory regime in which they operate, the risks they face, and how these are managed.
- Given the nature of banks' activities, their fiduciary and custodial duties, and the high volume of monetary transactions carried out by many banks, some of which may be complex, they need robust internal control systems. Otherwise, banks risk breaching regulatory requirements, by failing to conduct orderly and prudent operations, or to prepare financial statements

¹ www.bis.org/bcbs/commentletters/ifac45.pdf

that comply with the relevant financial reporting framework. We therefore believe there is a need for more application material on the specific risks arising from inadequate internal control systems in banks.

Overall, we support the IAASB's initiatives to improve the auditor's risk assessment procedures. In particular, this is the case because of the interplay between ISA 315 and ISA 540 (Revised),² which is of utmost relevance for us. As we believe the enhancements in ED-315 are developments in the right direction and we strongly support them.

The following improvements are particularly important to us:

- introduction of new concepts such as inherent risk factors and spectrum of inherent risk;
- clarification that the auditor should perform a separate assessment of inherent risk and control risk;
- approach of scalability;
- introduction of a "stand-back test";
- additional emphasis in the standard and application material that focuses on obtaining a sufficient understanding of information technology (IT); and
- references to the use of automated tools and techniques, including data analytics, to perform risk assessment procedures (application material and flowchart).

Although the Committee is aware of the IAASB's current stance toward auditing standards as being applicable for all audit engagements, the Committee holds the view that auditing standards should also be appropriate for audits of complex entities including, in particular, audits of entities in the financial industry (notably banks). The Committee encourages the IAASB to ensure that new standards and revisions to existing standards touch upon the risks of material misstatement arising in audits of complex entities, including appropriate consideration of underlying internal systems and procedures. The Committee would prefer this material to be included in the "requirements" section for auditing standards. However, if the IAASB were to decide that it would be best to address industry-specific requirements and guidance outside the standards, for example in an International Auditing Practice Note (IAPN) or other material, the Committee urges the IAASB to take up such work as soon as possible.

The Committee welcomes the central role that professional skepticism plays in ED-315. Specific focus has been placed on the auditor's understanding of the entity and its environment, and in the auditor's ability to effectively exercise professional skepticism throughout the audit. However, the Committee believes that the standard needs to go further to reinforce the need for professional skepticism, and has provided a number of recommendations in its answer to Question 4 in the annex to this letter. In particular, the Committee recommends that the IAASB reinforce the need for professional skepticism by giving it greater prominence within the "requirements" section of ISA 315 (Revised), and not just in the application material.

² ISA 540 (Revised) Auditing Accounting Estimates and Related Disclosures.

We hope you find our comments constructive and helpful. This letter has been prepared by the Committee's Accounting Experts Group, chaired by Fernando Vargas Bahamonde, Associate Director General of the Bank of Spain. If you have any questions regarding these comments, please contact Mr Vargas (+34 913 38 61 04), Nic van der Ende, chair of the Committee's Audit Subgroup (+31 20 524 91 11), or Ruby Garg or Masaya Hatoma at the Basel Committee Secretariat (+41 61 280 8463/+41 61 280 8577).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Stefan Ingves', is centered on the page. The signature is fluid and cursive, with a large initial 'S' and 'I'.

Stefan Ingves

Annex

Question 1) Has ED-315 been appropriately restructured, clarified and modernized in order to promote a more consistent and robust process for the identification and assessment of the risk of material misstatement?

The flowcharts are particularly helpful in navigating through the requirements of the standard. One area where flowcharts may have benefit is to address the scalability issue. In particular, flowcharts may help auditors to navigate through the standard when complex risk areas are encountered during the course of an audit as well as in much simpler situations. In this sense, we would also encourage the IAASB to develop flowcharts that address complex risk areas. The section entitled “Key Concepts” provides a useful introduction and overview.

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?

We understand the approach to scalability expressed in paragraph 13, eg the standard (including the principles) is intended for all entities and the application material includes considerations specific to audits of smaller, less complex entities. However, this paragraph seems to be the only mention of scalability in ED-315 and in our view is overly broad.

We would emphasise, however, that the complexity of banks’ business models and expected credit loss (ECL) accounting frameworks complex internal models for estimating ECL within banks. Thus, it could prove to be very difficult for auditors to independently develop their own model for ECL estimates. In that situation, the auditor should emphasise the assessment of (i) the appropriateness of internal processes, including assumptions, and controls; (ii) the reasonableness of management’s ranges and point estimates; and (iii) the model’s theoretical soundness and mathematical integrity. We recommend that the “requirements” section or application material in ISA 315 (Revised) should recognise these complex risk areas and set out the required audit response.

In particular, to more fully address accounting estimates that have high estimation uncertainty or complex models, such as ECL estimates, the IAASB should revise ED-315 to treat the risks of material misstatement associated with these estimates to be a significant risk. Paragraphs 39(b) and 42 of ISA 315 (Revised) require the auditor to identify controls that address risks identified as a significant risk, evaluate whether these controls are designed effectively and determine whether they have been implemented. When these conditions are present, we believe as a next step that the standard should require auditors to test the operating effectiveness of internal control over ECL estimates and other complex accounting estimates as part of their risk assessment procedures.

In addition, we acknowledge that several references to analytical procedures are included in the application material, eg in paragraphs A32 and A33 of ED-315. However, we would recommend moving these two paragraphs in particular into the “requirements” section of the standard.

The application material could also be clarified in some places (eg in paragraphs A47 and A49) to explain that audit procedures may vary in relation to the size and complexity of the audited entity, although the objective of these procedures remains unchanged. The audit objective is always to obtain a sufficient understanding of the entity, its environment, the applicable financial reporting framework and the entity’s system of internal control, regardless of its size and complexity.

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 in 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?

All references to automated tools are in the application material or appendix. We would recommend that the “requirements” section of the standard, eg paragraph 18 of ED-315, include a reference to automated tools as their use is prevalent today. In this regard, we note that the Executive Summary in the Explanatory Memorandum for ED-315 states that the standard has been revised to explicitly acknowledge how auditors may use automated tools to perform risk assessment procedures.

Question 4) Do the proposals sufficiently support the appropriate exercise of professional skepticism 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 skepticism?

The IAASB’s developments that we welcome in ED-315

We acknowledge that the IAASB has recognised the central role that professional skepticism plays in an audit. We welcome that ED-315 contains several key provisions that are intended to reinforce the auditor’s exercise of professional skepticism, such as placing the focus on a more thorough and robust understanding of the entity and its environment as well as its applicable financial reporting framework. This provides a good foundation for promoting the exercise of professional skepticism throughout the audit process.

In this regard, we also welcome that in ED-315,

- paragraphs 22 and A44 implicitly require the engagement partner and other key engagement team members to apply professional skepticism during engagement team discussions about the applicable financial reporting framework;
- paragraph A42 highlights how engagement team members can learn from more experienced colleagues; and
- paragraphs A19, A44 and A135 state that contradictory evidence may be obtained as part of the auditor’s risk assessment process.

Recommendations in general and for paragraphs 17 and 18 of ED-315

We would recommend that the “requirements” section of the standard explicitly recognise the need for the auditor to exercise professional skepticism. The Explanatory Memorandum highlights six paragraphs within the application material that deal with professional skepticism. However, there is no explicit reference to professional skepticism within the requirements themselves. Adding narrative to the requirements would serve to reinforce the importance of professional skepticism and establish a standard that more strongly promotes audit quality, and would also be consistent with ISA 540 (Revised), which includes narrative in the standard. For example, paragraph 34 of ISA 540 (Revised) highlights that, when evaluating information, all information corroborative or contradictory should be taken into account. A

specific section in the “requirements” section of ED-315 headed “professional skepticism”, similar to ISA 200,³ would give the issue even more prominence.

Specifically, we believe paragraphs 17 and 18 of ED-315 (including the related application material) should be supplemented with additional wording that supports the appropriate exercise of professional skepticism while performing procedures to understand an entity and its environment, its financial reporting framework, and its system of internal control as a basis for identifying and assessing the risks of material misstatement.

Documentation

We acknowledge that the IAASB has expanded the specific requirements in ED-315 on documentation. However, ED-315 should contain an explicit requirement for the documentation of the auditor’s application of professional skepticism in paragraph 54 (“Documentation”) rather than relying on the reference to overall documentation requirements in accordance with ISA 230.⁴

Information received from management

The proposals generally focus on obtaining and considering “contradictory information” (eg as in paragraphs A19, A42 and A43). However, the Committee recommends making ED-315 more emphatic by stating in the “requirements” section that auditors should critically assess and challenge the information they receive from management. Further details could be included within the application material (eg in paragraphs A21–A23 (“inquiries of management”)) to emphasise that when inquiring of management, auditors should be prepared to critically assess and challenge the information they receive.

Judgments made by management

We recommend that ED-315 be revised to focus the auditor’s attention on significant judgments made by management in its preparation of financial statements because such judgments are very likely to affect the auditor’s assessment of the risks of material misstatement and may represent significant risks. Therefore, the auditor’s consideration of management’s significant judgments should be part of the risk assessment procedures and related activities (and hence within the scope of ISA 315 (Revised)). The application material refers only to management bias (eg in paragraphs A44 and A52).

Information used since prior years

Paragraphs A38 and A40 recognise that the auditor may have information from other engagements or prior year audits, which can inform the auditor’s understanding and assessment of the entity. Paragraph A40 includes a warning that the auditor should ensure that the information derived from prior year audits remains relevant and reliable. However, paragraph A38 does not have a similar warning in respect of information from other engagements. Paragraphs A38 and A40 relate to different sources of information, to which the same concerns apply. The text in paragraph A38 should have a degree of commonality with paragraph A40, and should prompt the auditor to consider whether information from other engagements is relevant to the audit.

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

³ ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.

⁴ ISA 230 Audit Documentation,

the work effort required and the relationship of the work effort to the identification and assessment of the risks or material misstatement?

In general, the proposals seem clear in addressing all components of the system of internal control, the link between the understanding obtained and the risk assessment process and the requirements for auditors.

We would like to emphasise the importance of understanding applicable laws and regulations. While it is mentioned that compliance is a part of the system of internal control, the definition of compliance with laws and regulations does not seem to expressly cover or include compliance **with prudential regulations**, which for banks is a priority. Our suggestion would be to expand the definition and therefore include the understanding of applicable prudential laws and regulations in the risk assessment phase.

IT-related concepts and definitions (Question 5c)

We welcome the increased recognition of IT as an issue that auditors need to consider.

Nevertheless, we recommend that the standard address the nature and extent of IT outsourcing (and possibly outsourcing more generally) by the entity as an activity that the auditor should understand. As drafted, ED-315 contains only one brief reference to IT outsourcing in the application material (ie in paragraph A148 of ED-315).

IT outsourcing is an activity that has been growing in recent years and it introduces new risks and issues around data storage and management that the auditor will need to understand and assess. For example, it is important that the auditor understands the location of data relevant to the audit of the financial statements and whether those data are held by a third party, whether the auditor has access to that data, what security exists around the data, and what management's controls are around the outsourcing arrangement.

Some possible amendments that the IAASB should consider are:

- Paragraph 23(a)(i) could reference the need to understand the usage by, or reliance of, the entity on third-party providers of IT services; and
- Paragraph 35 could introduce the need to understand the location of data and the involvement of third parties in its storage and management, with further elaboration in the application material (ie in paragraphs A55, A61, and A136–A141).

Other wording suggestions for the requirements

We were encouraged by the statements regarding “Control Environment” (paragraphs 27–28), but paragraph 39(a) of the “Controls Relevant to the Auditor” section addresses risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. It should be made clear that, for complex estimates when the risk of material misstatement is high, it will be rare that substantive procedures alone will provide sufficient appropriate audit evidence. This would include ECL estimates.

In addition, the sequence of items in paragraph 39 is confusing. Paragraph 39(d) refers to testing the operating effectiveness of controls and paragraph 39(e) then addresses evaluating their design. Paragraph 42 of ED-315 does require the auditor to evaluate whether a control is designed effectively. Because the evaluation of the design must take place before the testing of operating effectiveness, paragraph 39(d) and (e) should be reversed.

Other wording suggestions for the application material

Paragraph A168 states, in part, “The auditor is required ... to design and perform tests of relevant controls that address the risks of material misstatement”. However, it should be made

clear in paragraph A168 that before a control can be tested it should be evaluated for effectiveness. That is addressed in paragraph A179, which covers “the auditor’s evaluation of the design of these controls”. Again, because the evaluation must always come first, the IAASB should consider whether paragraph A179 should precede paragraph A168.

Paragraph A229 states “Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because these are likely to give rise to risks of material misstatement at the assertion level that are assessed as close to the lower end on the spectrum of inherent risk.” This could be misunderstood and deter the auditor from testing the controls over routine non-complex transactions. We believe that a high volume of routine transactions could, in a number of circumstances, pose a significant risk of material misstatement, eg if a high volume of routine transactions outstrips the capacity of the systems to effectively process them. To avoid any misunderstanding, paragraph A229 of ED-315 should explicitly recognise that routine non-complex transactions in some circumstances could also be associated with higher inherent risk.

Question 8) What are your views about the proposed stand-back requirement in paragraph 52 of ED-315 and the revisions made to paragraph 18 of ISA 330 and its supporting application material? Should either or both requirements be retained? Why or why not?

Stand-back testing

We welcome the proposed “stand-back” provision in paragraph 52 of ED-315 for all classes of transactions, account balances and disclosures. This is in line with the requirements in ISA 540 (Revised) for accounting estimates.

In “standing back”, the auditor reconsiders the possibility that any “qualitatively or quantitatively material” classes of transactions, account balances and disclosures, which have not been determined to be significant upon initial risk identification and assessment, continue to be non-significant or could be significant in accordance with paragraphs 16(k) and 46 of ED-315. This is meant to reinforce the completeness of the identification of the risks of material misstatement.

In addition, we believe that there should be separate “stand-back” tests in ED-315 and ISA 330.⁵ because the “stand-back” concept is important in the risk assessment phase of designing the audit as well as in designing the audit responses.

We recommend that ISA 315 (Revised) be revised to require that any further audit procedures performed (as in accordance with paragraphs 6 and 18 of ED-315) be responsive to the assessed risks of material misstatement (in line with the ISA 540 (Revised) requirements for accounting estimates). Furthermore, we agree with the conforming and consequential amendments to ISA 330, especially to paragraphs 18 and A42 of ISA 330 arising from paragraph A42 of ED-315.

In addition, the narrative in the application material (ie paragraphs A240–A242 of ED-315) should be clarified to provide adequate guidance in respect of paragraph 52(b). According to paragraph 61 of the Explanatory Memorandum, the stated purpose of the stand-back test is to “drive an evaluation of the completeness of the significant classes of transactions ...”. The narrative in paragraphs A240–A242 seems to indicate that ISA 330 is the relevant standard for matters that are material, but are not significant, eg the narrative does not suggest a re-evaluation of whether all significant transactions have been identified. The application material

⁵ ISA 330 The Auditor’s Responses To Assessed Risks.

in ED-315 should incorporate some of the narrative statements from paragraphs 61 and 62 of the Explanatory Memorandum, particularly as regards the purpose of the test.

Linkage to ISA 330

ISA 330 addresses the design and performance of further audit procedures responsive to the assessed risks of material misstatement. In this regard, ISA 330 distinguishes between “significant” and “material” classes of transactions, account balances and disclosures. In general, the procedures to be performed for “material” assertions are less intensive as these are not considered “significant”, but still require the auditor to design and perform substantive procedures (see paragraph 18 of ISA 330).

Against this background, we recommend that paragraph 52 of ISA 315 (Revised) should contain a stronger linkage to paragraphs 18 and A42 of ISA 330. Paragraph 52 addresses the auditor’s identification of material classes of transactions, account balances and disclosures that have not been identified as significant and whether the auditor’s conclusion that they present no related risks of material misstatement remains appropriate. Taken together, paragraphs 18 and A42 state that an auditor who identifies a class of transactions, account balance or disclosure that is quantitatively or qualitatively material, regardless of whether the assertion is significant, must design and perform substantive procedures for the assertion unless such procedures have already been performed.

In our view, paragraph 18 of ISA 330 sets forth an important requirement for auditors because it safeguards against insufficient risk identification and assessment (“irrespective of the assessed risks of material misstatement” [at the assertion level]) by preventing situations in which further audit procedures for each material class of transactions, account balance and disclosure would only include tests of controls.

Question 9) With respect to the proposed conforming and consequential amendments to:

b) ISA 330, are the changes appropriate in light of the enhancements that have been made in ISA 315 (Revised), in particular as a consequence of the introduction of the concept of general IT controls relevant to the audit?

Considering the significance of the changes made to ISA 315 (Revised) and the consequential amendments to ISA 330, we believe it is important for the IAASB to further review ISA 330 with the objective of making appropriate revisions that take into account current developments in auditing (eg greater use of automated tools and techniques, IT as the medium for obtaining audit evidence).

d) ISA 540 (Revised) and related conforming amendments (as presented in the Supplement to this exposure draft), are these appropriate and complete?

We agree with the conforming amendments to ISA 540 (Revised).