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November 2, 2018

Mr. Daniel Montgomery
Interim Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th Floor
New York, New York 10017 USA

RE: Exposure Draft, Proposed International Standard on Auditing 315 (Revised),
*Identifying and Assessing the Risks of Material Misstatement and Proposed
Consequential and Conforming Amendments to Other ISAs*

Dear Mr. Montgomery:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs. This letter represents the perspectives of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ appreciates the opportunity to share our views and provide input on the International Auditing and Assurance Standards Board (IAASB or Board) Proposed International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement and Proposed Consequential and Conforming Amendments to Other ISAs* (the Exposure Draft or ISA 315 (Revised)).

The CAQ is supportive of the IAASB's efforts to consider ways to strengthen auditing practices to continuously improve audit quality. We note the importance of risk assessment to audit quality and believe the ISAs should be clear as to what is expected of auditors to perform a robust risk assessment, taking into account the nature and size of the entity. We recognize that the Board has been working diligently on this project since early 2015 and appreciate its outreach and responsiveness to concerns raised by key stakeholders.

In this letter, we offer for the IAASB's consideration our views regarding certain topics outlined in the Exposure Draft, in particular where we think the proposed standard needs to be clarified to achieve the IAASB's intended objectives. The proposed requirements are at risk of being interpreted differently by auditors, which could lead to inconsistent application of the final standard if not addressed. The proposed changes also could have a significant cost impact, including with respect to many firms' methodologies and technologies, with little associated benefit.

As an example, we are concerned about the manner in which the requirements have been set out in the Exposure Draft, which could infer that a specific approach must be followed. We do not believe this is appropriate considering the range of entities to which the standard will need to be applied and the IAASB's desire to set forth a scalable standard. The Exposure Draft should allow sufficient flexibility for firms to adopt a range of approaches to applying the risk assessment requirements, perhaps first determining significant classes of transactions, account balances, and disclosures and then considering relevant assertions, or considering these concurrently. We suggest this be clarified in the introductory material in the Exposure Draft.

Our views are organized into the following sections:

- I. Understanding the Entity's System of Internal Control
- II. Identifying and Assessing the Risks of Material Misstatement
- III. Scalability
- IV. Professional Skepticism
- V. Effective Date
- VI. Conclusion

I. Understanding the Entity's System of Internal Control

Obtaining Sufficient Appropriate Audit Evidence as the Basis for the Identification of the Risks of Material Misstatement

We do not support the reference in paragraph 17 to obtaining "sufficient and appropriate audit evidence", particularly in relation to the entity's system of internal control, as the basis for the identification and assessment of risks of material misstatement. This creates an open-ended judgment and could represent a significant change in practice in circumstances where auditors intend to perform a more substantive audit. While performing risk assessment procedures does provide evidence and we support prompting the auditor to question whether their basis is sufficient, we believe the approach in extant ISA 315 (Revised) is preferable. The purpose of the auditor's risk assessment is to design an appropriate response, thereby obtaining sufficient appropriate audit evidence to support the auditor's opinion on the financial statements taken as a whole. The approach in extant ISA 315 (Revised) could be strengthened by updating paragraph 17 in the Exposure Draft to read as follows: "...to obtain a sufficient ~~appropriate audit evidence as the basis~~ **understanding to provide a reasonable basis for** identification and assessment of risks of material misstatement at the financial statement and assertion levels, **and designing further audit procedures...**"

Level of Effort to Understand the Entity's System of Internal Control

As set forth in the Explanatory Memorandum that accompanied the Exposure Draft, the IAASB intended to clarify in the Exposure Draft what is meant by "controls relevant to the audit", what is expected of auditors to obtain an understanding of controls, and how the concept of controls relevant to the audit relates to the

information system. However, we do not think that objective has been met. It is essential that the IAASB's efforts result in greater clarity as to what is expected of auditors with respect to internal control to minimize confusion and inconsistency in application.

We are concerned that the potential implications of a separate "assessment" of control risk have not been appropriately considered, nor is the Exposure Draft sufficiently clear about the nature of what is expected. While auditors do consider control risk in identifying and assessing risks of material misstatement, it is in the context of whether to obtain evidence from evaluating the design, implementation and operating effectiveness of controls. Auditors also consider control risk when performing substantive procedures, either alone or in combination with control procedures in the risk assessment and planning stage, to help determine the planned control reliance. Therefore, we believe it is necessary for the final standard to clearly illustrate that auditors may think about this assessment within their methodologies in a variety of ways, including by considering how planned controls reliance can appropriately reduce the overall risk of material misstatement.

Paragraphs 27 to 38 of the Exposure Draft outline the requirements the auditor should perform to obtain an understanding of each component of internal control. Paragraph A90 of the Exposure Draft provides guidance that the nature, timing, and extent of risk assessment procedures that the auditor performs to obtain an understanding of each component of internal control are matters of the auditor's professional judgment. In particular, the auditor's approach to understanding the entity's system of internal control could vary based on the size and complexity of the entity, as well as prior experience with the entity, and still be in compliance with the requirements. We would recommend the introductory paragraphs of the final standard make specific reference to the fact that the ISA requires the auditor to perform risk assessment procedures that, in the auditor's judgment, are appropriate based on the size and complexity of the entity.

The language in paragraph 39 correctly notes that not all controls relevant to financial reporting are relevant to the audit. However, the requirement in paragraph 36 to evaluate the design and implementation of system controls relevant to financial reporting is too broad and should be clarified. The focus in paragraph 36 should be on identifying controls relevant to the audit within the information system component, and evaluating the design and implementation of those controls, following on from the requirement in paragraph 35 to understand the information system. We also find the introduction of the term "information system controls relevant to financial reporting" to be confusing when compared to paragraph A157.

Terms Used to Describe Aspects of the Entity's System of Internal Control

Similar to the definition of *Internal Control* in extant ISA 315, the definition of the *System of Internal Control* in the Exposure Draft makes reference to achieving operational and compliance objectives. We recommend the Exposure Draft make clear that, while the system of internal control would include processes and controls related to operational and compliance objectives, not all of the entity's objectives and controls are relevant to the auditor's assessment of the risks of material misstatement at the financial statement and assertion levels. For example, the auditor's responsibility for internal control related to cybersecurity and/or privacy would be limited to those cybersecurity or privacy controls relevant to the audit.

Paragraph 16(d) of the Exposure Draft defines controls as, "Policies or procedures that are embedded within the components of the system of internal control to achieve the control objectives of management or those charged with governance. Within this context, policies are statements of what should or should not be done within the entity to effect internal control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions. Procedures are actions to implement policies."

We note this definition comes from the Committee of Sponsoring Organizations (COSO), but believe additional context is necessary to describe that internal control is a process consisting of ongoing tasks and activities that is impacted by people.

Similarly, we note the definition of controls refers to policies, including those implied through actions and decisions. While this aligns with COSO, we believe additional context would be necessary to operationalize the term in an audit context to support the expanded requirements for auditors to evaluate design and implementation of controls relevant to the audit. Evaluating the design and implementation of a control implied through an action or decision can be difficult. We recommend application guidance be added to the Exposure Draft to describe the nature and extent of procedures an auditor could perform, such as observation of activities or inspection of less formal documentation, when documentary evidence of the operation of the control might not exist. We note this guidance may be particularly relevant for auditors dealing with less sophisticated entities.

Paragraph 16(a) of the Exposure Draft defines application controls, but the concept of transaction controls is not included. We are concerned that an auditor will see the term application controls and think the Exposure Draft is referring to automated controls only. We recommend adding an application paragraph to the Exposure Draft. This application paragraph related to understanding the entity and its control environment could suggest the auditor think about the framework that management has used, if any, to develop the entity's control environment. The application paragraph could also include example frameworks, such as COSO.

II. Identifying and Assessing the Risks of Material Misstatement

Inherent Risk Factors

We believe the use of the inherent risk factors could assist auditors in making more robust risk assessments and designing appropriate responses to the assessed risks. However, we are concerned about the inclusion of susceptibility to misstatement due to management bias or fraud as a discrete inherent risk factor in the Exposure Draft given the interaction between ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of the Financial Statements* (ISA 240) and extant ISA 315 (Revised). Paragraph 25 of ISA 240 already requires the auditor to identify and assess the risks of material misstatement due to fraud at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures. ISA 240 also sets out robust fraud risk factors for the auditor to evaluate. Inclusion as a separate inherent risk factor in the final standard will lead to confusion between the two standards or in how the two standards interact. We also note that susceptibility to fraud may also arise as a result of a weak control environment or deficiencies in internal control. Therefore, we do not believe this can be thought of in the context of inherent risk only, in isolation from understanding the entity's system of internal control. We suggest the relationship between ISA 240 and ISA 315 (Revised) be clarified by making reference to the requirements and guidance in ISA 240 as additional application material in paragraph A6 of the Exposure Draft. If considered necessary, essential explanatory material could be incorporated into paragraph 45 of ISA 315 (Revised) to remind auditors that the auditor's risk assessment includes the auditor's assessment of the risk of material misstatement due to fraud in accordance with paragraph 25 of ISA 240.

We agree with the position set out in paragraph A245, which explains the auditor is not required to document every inherent risk factor that was taken into account in identifying and assessing the risks of material misstatement at the assertion level. However, it may not be sufficiently clear what is expected in

terms of the requirement in paragraph 54(d) for the auditor to document the rationale for the significant judgments made in identifying and assessing the risks of material misstatement.

Significant Risks

According to the Exposure Draft, the Board's intent in changing the definition of significant risk was to promote a more consistent approach to determining significant risks.¹ As currently drafted, we do not believe this objective can be met, as determination of whether a risk is significant is still largely a matter of professional judgment and auditors could ultimately determine that there are no significant risks depending on the facts and circumstances of the engagement.

The definition of *Significant Risk* in paragraph 16(k) refers to the likelihood of a misstatement occurring **or** the magnitude of a potential misstatement (emphasis added). We recommend that the definition be revised to refer to the likelihood of a misstatement occurring **and** the magnitude of a potential misstatement. As an example, we do not believe that a risk of material misstatement with a high likelihood of occurrence but a remote likelihood of being material (both quantitatively and qualitatively) should be assessed as a significant risk. Conversely, a potentially material misstatement with a remote likelihood of occurrence should not be assessed as a significant risk. We support the application guidance in paragraph A222 explaining that positioning on the spectrum of inherent risk is determined by both the likelihood **and** magnitude (emphasis added), and that significant risks are those close to the upper end of the spectrum of inherent risk.

The third sentence in paragraph A10 could be viewed as inconsistent with the definition of significant risk in paragraph 16(k) of the Exposure Draft. It is circular and could imply that the auditor also should consider whether a risk is significant based upon the potential audit procedures to be performed when in fact the assessment of risk informs the audit response. We recommend removing this sentence.

Relevant Assertions

We are supportive of the term "reasonably possible" in the revised definition of *Relevant Assertions* in paragraph 16(h) of the Exposure Draft.

Significant Classes of Transactions, Account Balances, and Disclosures

The definition of *Significant Classes of Transaction, Account Balances, and Disclosures* in paragraph 16(j) does not specifically refer to transactions, account balances, and disclosures significant to the financial statements. Instead, the definition refers to relevant assertions and appears circular in nature. We recommend that the definition make it clear that the auditor should obtain an understanding of classes of transactions, account balances, or disclosures that are significant to the financial statements. This could be done by revising the definition of *Significant Classes of Transactions, Account Balances, and Disclosures* to read as follows: "A class of transactions, account balance, or disclosure for which there is a reasonable possibility that the class of transactions, account balance 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. A significant class of transactions, account balance, or disclosure includes one or more relevant assertions."

¹ See page 21 of the Exposure Draft.

In addition to revising the definition, we recommend the Board provide clarity on how to apply the definition of *significant classes of transactions, account balances, and disclosures*. We believe giving increased prominence to the concept of identifying significant classes of transactions, account balances, and disclosures earlier in the standard could assist in focusing auditor effort on understanding the entity's information system relevant to *significant classes of transactions, account balances, and disclosures*. This increased prominence also would assist with demonstrating scalability, by highlighting for auditors those classes of transactions, account balances, and disclosures on which the practitioner should focus.

Stand-back and Paragraph 18 of ISA 330

The Exposure Draft asks a specific question on whether the proposed stand-back requirement in paragraph 52 of ISA 315 (Revised) and the revisions made to paragraph 18 of ISA 330, *The Auditor's Responses to Assessed Risks*, should be retained. It is not necessary to retain the proposed stand-back requirement in ISA 315 (Revised) or the proposed change to make reference to "qualitatively material" in paragraph 18 of ISA 330. The IAASB states in the Exposure Draft that the Board is of the view that a more robust (and specific) process to identify and assess risks of material misstatement will result in auditors developing responses that are more targeted and responsive to the assessed risks of material misstatement.² We believe that when applying the inherent risk factors described in paragraphs A5 and A6 of the application guidance, the auditor would identify those classes of transactions, accounts or disclosures that are significant to the financial statements, including the example provided in paragraph A241, making the proposed changes redundant.

Flexibility in Applying Requirements of the Exposure Draft

We agree with the statement in paragraph A225 that the auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies.³ Similarly, the same is true for inherent risk. The Exposure Draft also appropriately highlights that the auditor's risk assessment process is iterative and dynamic.⁴ However, the manner in which the requirements have been set out, and some language used in those requirements, could infer that a specific approach must be followed. For example, paragraph 9 discusses "initial expectations about the potential risks of material misstatement and the potential significant classes of transactions, account balances and disclosures." We believe this is meant to align with paragraph 45, although that requirement could be viewed more as redundant to the requirements in paragraphs 47-49. We also have some concern that the manner in which the risk assessment process is described may set out an expectation that more formal documentation of a "preliminary risk assessment" would be required, which we do not believe is necessary. The Exposure Draft should allow sufficient flexibility for firms to adopt a range of approaches to risk assessment, perhaps first determining significant classes of transactions, account balances and disclosures and then considering relevant assertions, or considering these concurrently. We suggest this be clarified in the introductory material in the Exposure Draft.

III. Scalability

It is important that any improvements to existing auditing standards result in scalable requirements and application material that audit firms of all sizes can apply to companies of all sizes. The identification and

² See page 26 of the Exposure Draft.

³ Paragraph A225 of the Exposure Draft.

⁴ Paragraph 9 of the Exposure Draft.

assessment of risks should not be based on the size of the entity or audit firm. We are supportive of the removal of “considerations specific to smaller entities” throughout the Exposure Draft. We also are supportive of the introduction of application material that provides considerations for audits of entities that are both smaller and less complex contrasted with considerations for audits of entities that are larger and more complex. However, we are not convinced that the application material as drafted clearly demonstrates that the standard is scalable. The final standard should more explicitly acknowledge the variability of entities to which the standard will apply, and efforts should be made by the IAASB to ensure the requirements are sufficiently principles-based so they are capable of being appropriately scaled, with guidance to support those requirements. In this regard, clarifying the extent of understanding of internal control and how the concept of controls relevant to the audit applies when auditors intend to take a more substantive approach to obtaining evidence is essential.

We also have concerns about the length and complexity of the standard. We believe that having the large number of requirements and paragraphs of application material, and multiple flow charts could indicate potential scalability issues and could obscure the most relevant guidance, impairing the auditor’s ability to scale or apply the requirements in the Exposure Draft to smaller entities. We encourage the IAASB to continue to consider what additional actions may be needed to demonstrate the scalability of the standard in light of its length and complexity, for example considering whether other mechanisms to provide implementation guidance may be more effective, such as guides and tools.

IV. Professional Skepticism

In the CAQ’s 2016 comment letter to the IAASB,⁵ we recommended that as the IAASB contemplates revisions to existing standards or the development of new standards, they consider whether to include application material within the standard that would help guide the auditor’s appropriate application of professional skepticism. The changes proposed in the Exposure Draft align with that recommendation.

V. Effective Date

The preparation for and implementation of the proposed requirements in the Exposure Draft could take a considerable amount of time. The length and the complexity of the Exposure Draft will require significant investment of both time and resources to fully evaluate the impact of the standard and implement it accordingly. Audit firms will need to develop effective quality control processes, as well as updates to methodologies, new training, and technology changes to support implementation of the new and revised requirements. Such efforts will need to be finalized well in advance of risk assessment procedures commencing.

Successful implementation will require proactive monitoring of implementation by the IAASB. For example, the IAASB may need to consider developing additional guidance in those areas that may be most challenging to implement to help ensure consistent implementation. If the IAASB believes the flowcharts in the Exposure Draft should be published with the final standard, we would be supportive of them being included in a guide (outside the final standard) to allow for flexibility in applying the requirements of the standard and allow for any changes needed to the flowcharts in the future.

⁵ See [CAQ comment letter response](#) to the IAASB’s *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*.

We also recognize that ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* (ISA 540 (Revised)) is now effective. The IAASB should consider releasing transition guidance prior to the effective date of the Exposure Draft related to, for example, how elements of the revised approach in ISA 315 (Revised) would be expected to apply during the implementation of ISA 540 (Revised).

We encourage the Board to take these matters into consideration when determining if an effective date of 2021 will allow audit firms and preparers the necessary time to develop the appropriate processes, policies and procedures to implement the new standard.

VI. Conclusion

We appreciate the opportunity to comment on the Exposure Draft. As the IAASB gathers feedback from other interested parties, we would be pleased to discuss our comments or answer any questions that the IAASB may have regarding the views expressed in this letter.

Sincerely,



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Executive Director
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cc:

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