

IAASB
International Auditing and Assurance Standards Board

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Subject: Response from FSR – danske revisorer (FSR – Danish Auditors) to the IAASB Consultation Paper on the Exposure Draft, ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement

Dear Sir or Madam,

FSR – Danish Auditors is pleased to provide you with our response to IAASB's Consultation Paper on the Exposure Draft, ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement.

We support the IAASB's decision to explore this topic. However, we do not support this exposure draft in its current form.

In our view, the standard should be redesigned, employing a building block approach. The standard should start with its foundation, being the risk assessment requirements for the audit of small and less complex entities. Additional requirements can then be added (building blocks) when assessing risk and internal control systems for audits of large or more complex entities. This will make the standard easier to understand and apply in practice. We believe this is both in the interest of the vast majority of the auditors that are going to apply the standard and of the public in general, to secure an efficient and robust risk assessment.

We are concerned that the length and complexity of the standard will make it difficult to understand and apply in practice, which in turn will not help improve the risk assessments that auditors perform.

Please refer to appendix 1 for our detailed answers to the questions stated in the invitation to comment.

For further information on this letter, please contact Louise Nellemann at lne@fsr.dk

Kind regards,
On behalf of FSR – danske revisorer

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Appendix 1

Overall Questions

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 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 risk of material misstatement and do they appropriately address the public interest issues outlined in paragraphs 6-28?**
- c) **Are the new introductory paragraphs helpful?**

In our opinion the proposed changes to ED-315 will not create a more understandable and robust process for the identification and assessment of the risks of material misstatement.

From our perspective, it is imperative that the standard creates a consistent and effective approach to risk assessment through clear and robust requirements that are based on the audit of small and less complex entities, while at the same time being capable of being scaled to large complex audits.

The new definitions and concepts in ED-315 do not, as we read and understand them, clarify the risk assessment process, but in fact introduce a level of complexity that increases the risk of inconsistent understanding and application of the requirements. This is for example, illustrated by the fact that it is not possible to read and understand ISA 315 ED without using the flowcharts as guidance. Furthermore, the standard has more than 80 pages that, in general, are applicable to almost any audit. In our view, this complexity is especially driven by the sections dealing with "Obtaining an understanding of the Entity's System of Internal Control", paragraphs 25-44, and "Identifying and Assessing the Risk of Material Misstatement", paragraphs 45-53.

The section covering "Obtaining an understanding of the Entity's System of Internal Control" is overly complex because each of the components of internal control need to be assessed, as well as the judgment and extent of test of design and implementation of controls involved.

The section covering "Assessing the Risk of Material Misstatement" is overly complex because risks have to be identified at the assertion level and financial statement level, and linked to the "relevant assertion" and "significant classes of transactions, account balances and disclosures". This is further supported by the

inclusion of control risk in the risk assessment process, which creates an unclear basis for the audit responses that need to be designed to address the risk of material misstatements.

Side 3

The need for introductory paragraphs shows that the standard is too complex. In our view, the introductory paragraphs lack context when trying to summarise basic concepts. Consequently, we believe these paragraphs may confuse, rather than assist, auditors in performing robust and consistent risk assessments.

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?

As stated in our response to question 1, we do not believe that the standard is made sufficiently scalable because the standard is not appropriately designed for audits of small and less complex entities.

In our opinion, the standard should be designed differently to become truly scalable. In our view, the basic risk assessment should start with the requirements needed to assess risk and internal control systems for small and less complex entities, as for example described in the Nordic Auditing Standard (SASE). These basic requirements can then be expanded with more rigorous requirements needed to assess risk and internal control systems of more complex entities as well as public interest needs. This will, in our view, create a simpler and understandable standard, that is tailored to different auditors' needs when auditing different types of entities.

The overall length and complexity of the standard does, in our opinion, underpin that the standard is not appropriately designed for scalable application. In particular, we believe this is the case with the requirements on understanding the entity's system of internal control, that do not clearly describe where it would be appropriate for the auditor to do less.

In paragraph 13, the standard explains that the application material incorporates considerations specific to audits of smaller and less complex entities. The application material is only explanatory and, therefore, does not have the same authority as the requirements. This creates a fundamental challenge that needs to be overcome, as the scalability depends on the clarity of the requirements in the ISA's and how they apply to audits of varying 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?

A number of users of the extant ISAs believe that the ISAs need to be redrafted as they do not support the use of automated tools and techniques, including data analytics. It is important to make it clear to the users that the use of these tools is possible and to inform the users how these tools can help improve audit quality, including the robustness and effectiveness of the risk assessment, especially when auditing large complex entities.

Describing the possible use of automated tools and techniques in other places in the standard besides the application material would support the importance of using automated tools and techniques as part of the risk assessment.

As the relevance and importance of using automated tools and techniques increase with an entity's complexity, it could be relevant to include this as part of the scaling considerations. This could also be seen in the light of SMPs not having the same access to automated tools and techniques as larger firms.

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 and 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 what is the nature of the necessary guidance?

We do not believe that the proposal supports the appropriate exercise of professional scepticism as the standard does not state when professional scepticism is required to be exercised. The application material should help support how the professional scepticism should be exercised.

Furthermore, we believe there is a risk that the overall complexity of the standard may undermine the intended reinforcement of the importance of professional scepticism. This is due to the increased focus on specific requirements, rather than standing back and applying a questioning mindset, based on an understanding of the entity, the accounting framework and control environment.

We do not support that the auditor is required to obtain "sufficient and appropriate audit evidence" through the performance of risk assessment procedures to

provide a basis for the identification and assessment of the risks of material misstatement. This is because the ISAs define this as a threshold of evidence needed to form an opinion on the financial statements, which would create confusion as to the extent of procedures needed to be performed to identify and assess the risk of material misstatement.

Side 5

The concept of "sufficient and appropriate audit evidence" creates complexity in the standard and does also not support the scalability that is needed for audits of small and less complex entities, as one would be forced to perform walk-throughs and test of design and implementation of controls related to all processes, before sufficient and appropriate audit evidence is obtained.

In general, obtaining sufficient and appropriate audit evidence at an early stage of the audit seems premature as the risk assessment is an iterative process. The requirement is, therefore, in our opinion not realistic or practical.

Specific Questions

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 of material misstatement? Specifically:

- a) **Have the requirements related to 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 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 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 risks arising from IT and the identification of general IT controls sufficient to support the auditor's consideration of the effect of the entity's use of IT on the identification and assessment of the risks of material misstatement?**

- a) *The requirement to understand each component of the entity's system of internal control*

From a scalability standpoint, it is in our opinion not appropriate to require that all components of an entity's internal control system are understood. This is for example, the case where a decision is made by the auditor to apply a substantive based audit approach, rather than relying on and, therefore, testing internal controls more extensively.

In our view, the need to understand each component of internal control system should be scaled to the size and complexity of the entity being audited.

b) The requirement to identify "controls relevant to the audit"

In our view, it is not always clear when a control is relevant to the audit of small and less complex entities. This is especially the case when a fully substantive based audit approach is adopted.

The concept of controls relevant to the audit as used in paragraph 39(e) creates, in our view, uncertainty and ambiguity as it leaves an open-ended judgement as to whether it is "appropriate" to evaluate the design and implementation of controls. This coupled with the overarching requirement to obtain "sufficient appropriate audit evidence" from the auditor's risk assessment procedures, as a whole, results in a highly subjective and unclear threshold as to how much work is expected of the auditor.

It would be much clearer and more scalable if "controls relevant to the audit" were defined as "controls that are expected to be relied on to provide audit evidence". We often see in practice that testing of design and implementation of controls related to significant risks have no impact on the assessed risk of material misstatement and the procedures performed to address the significant risk. From a scalability perspective, the requirement to identify controls relevant to the audit should, therefore, be changed to only be required when necessary to understand the specific risk and to respond to that risk.

c) The introduction of new IT-related concepts and definitions

In general, the introduction of the new IT-related concepts and definitions is helpful for the understanding of the IT environment for larger and more complex entities. However, the level of complexity introduced is not relevant for most audits of small and less complex entities.

In our view, the requirements in the standard should describe what, as a minimum, is required when auditing small and less complex entities that use "off the shelf" software, and the requirements / application guidance should include additional considerations that should be made when the entity has a more complex IT environment.

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 misstatements, 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 assessment), 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?**

a) Separate assessments of inherent and control risk at the assertion level

In our opinion, the risk assessment would be more scalable if it was less process driven and more focused on the inputs that are needed to achieve the intended outcome. It is, therefore, unclear how the separate assessment of control risk and inherent risk at the assertion level improves the robustness and consistency of the risk assessment, and how it interacts with a fully substantive audit approach that will often be used on small and less complex entities.

We also believe that the definition and guidance for control risk needs to be revisited to fully address how this concept is applied in practice or be removed from the standard and instead be included in ISA 330.

b) Concepts and definitions of 'inherent risk factors'

The concept of 'inherent risk factor' and its definition is consistent with ISA 540. ED-315 provides sufficient guidance to explain how these risk factors are used in the auditor's risk assessment process.

c) The 'spectrum of inherent risk' (and the related concepts of assessing the likelihood of occurrence, and magnitude, of a possible misstatement)

In our opinion it should be made more clear how the auditor should, as part of his/her risk assessment, assess how the different risks of significant misstatements are placed on the risk continuum to make sure that an appropriate audit response can be designed.

d) The new concepts and related definitions of SCOTABD, and their relevant assertions

We find the new definitions difficult to read and rationalize. Overall, the new concept is difficult to understand and needs significant improvements to improve clarity.

e) The revised definition, and related material, on the determination of 'significant risks'

We do not agree that significant risks should be defined by reference to likelihood "or" magnitude, which will result in items that do not represent a significant risk being unnecessarily defined as such, for example certain classes of transactions, account balances or disclosures that may be highly material, but for which the likelihood of misstatement is very low.

This would for example, imply that any material balance in the financial statements would be at the upper end of the spectrum of inherent risk simply because, if misstated, the financial statements could be materially misstated. An assessment of the probability of misstatement does not appear to be taken into account.

In our view, this could distract the auditor's attention away from areas of high inherent risk and reduce scepticism by suggesting that all material items need to have the same degree of attention.

Question 7:

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

In our view, the additional guidance does not add any value. The additional guidance only states the obvious, which is that financial statement risks that are pervasive, increase the risk at the assertion level.

The requirements and related application guidance only add to the complexity of the standard. In our opinion, these pervasive risks, where identified, should be reflected in the assessment of risk of material misstatements in the financial statements, in a way that procedures can be designed to appropriately address the identified risks. For example, regarding going concern, where appropriate audit procedures need to be performed to ensure that the going concern principle is appropriately taken into account. The concept of identifying assertions is usually not relevant when addressing these types of pervasive risks, as it is only when the risk cannot be addressed that assertions become relevant.

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?

In our view, it is important to keep in mind that we perform risk based audits. For example, the scope of ED-315 is to identify and assess the risk of material misstatements in the financial statements.

In this perspective the stand-back requirement in paragraph 52 makes sense as it helps to ensure that the auditor has identified all relevant risks of material misstatements in the financial statements.

However, the requirement in paragraph 18 of ISA 330 is not consistent with a risk-based audit as it basically undermines the risk assessment process and the stand-back requirement by requiring procedures to be performed on areas that do not include risks of material misstatements.

We, therefore, propose that the requirement in paragraph 18 of ISA 330 should be removed as this will contribute to create a clear and more consistent risk assessment and a better basis for an efficient audit. The contrary, in our view, indicates that the standard setter does not believe that an appropriate risk assessment can be performed and, therefore, requires additional procedures to be performed on areas that do not include risks of material misstatements.

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 ISA 315 (Revised)?**
- b) **ISA 330, are the changes appropriate, in the light of the enhancements that have been made in ED-315, 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, are 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?**

In our opinion, ED-315 needs to be redrafted to address the issues, already stated, connected with scalability and excessive complexity before it is possible to consider if the corresponding amendments are appropriate.

However, in our view, ISA 240 and ISA 330 should be redrafted to ensure that the risk assessment process is simplified and made more scalable as the standards overlap and create unnecessary complexity when they do not promote a clear and consistent process that covers both risk of error and fraud.

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?

As stated in our response to question 8, we believe that the requirements in paragraph 18 of ISA 330 should be removed as they are redundant due to the inclusion of the proposed stand-back in ED-315. The alignment is, therefore, in our opinion not adding value.

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 – recognizing 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 note in reviewing the ED-315.**
- b) Effective Date – Recognizing that ED-315 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods beginning at least 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient**

The proposed revised standard is very difficult to understand and needs significant improvements to improve clarity. Difficulties understanding the standard will de facto lead to inconsistencies in translation.

It is crucial that the revision of the standard is given sufficient time, to make it a clear and simple standard that efficiently can be scaled so it can be applied to audits of small and less complex entities, as well as to large complex entities. In this context, the IAASB should set a more realistic timeline for revising this standard.