



PROPOSED INTERNATIONAL STANDARD ON AUDITING 315 (REVISED)

Issued 2 November 2018

ICAEW welcomes the opportunity to comment on the Proposed International Standard on Auditing 315 (Revised): *Identifying and Assessing the Risks of Material Misstatement* and Proposed Consequential and Conforming Amendments to Other ISAs (ED-315) published by IAASB on 1 July 2018, a copy of which is available from this [link](#).

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MAJOR POINTS

1. The issues these proposals are intended to address, particularly in terms of eliminating confusion and encouraging better quality and more consistent risk assessments, are at the heart of every audit. These objectives are in the public interest and are therefore important. The proposals will have far reaching effects because ISA 315 – arguably the single most important IAASB standard – is the ISA on which all other ISAs are based. For these reasons, we urge IAASB to take the time needed to get this right. The comments in this letter reflect the significance of this particular project to IAASB’s public interest mandate. In particular, as explained below, we have major concerns about the clarity of the proposals and their scalability.

Work is needed to ensure that the proposals are fit for purpose

2. Our outreach indicates that where field testing has been conducted, there are significant concerns. These include an overarching concern that the proposals, as they stand, have the potential to result in poorer, not better quality risk assessments. For our part, we are troubled by the fact that IAASB appears to have seen fit to expose these proposals prematurely. Evidence of this lies in the apparent lack of clarity and logic in several critical areas, and in the failure of the text to be comprehensible on its own. Without the supporting flowcharts, the text is extremely difficult to navigate. If these proposals are finalised too soon, the number of national standard-setters (NSS) who will come under pressure to develop their own auditing standards, particularly for the audit of smaller entities, will increase.
3. Given the amount of work needed to render these proposals fit for purpose, we are far from convinced that this standard can be finalised with an appropriate degree of consensus in June 2019, or that ED-315 can be rendered fit for approval without re-exposure. It is no exaggeration to say that millions of companies, many of them small businesses, will be affected by these proposals. While we understand the current pressures on IAASB to demonstrate that it can develop standards nimbly, it would be better to sacrifice a little time now rather than consign the world’s companies and their auditors to consequences of excessive haste for years to come. We strongly urge IAASB to take the time necessary to get this linch-pin standard right, in the public interest.
4. The proposals are cumbersome. They are written as if the standard were to be used as a methodology. While many clarifications are helpful, the level of over-engineering evident will inevitably create further confusion and inconsistencies. More work is needed before these proposals are finalised to eliminate unnecessarily lengthy and laboured constructions, and repetition, among many other things. We believe these proposals can, and should, be rendered more concisely.
5. There are particular problems with unstated assumptions about ‘and’ and ‘or’ constructions in the context of the description of smaller and less complex entities, and in the definition of significant risks. These could and should have been clarified prior to exposure and are in our view clear evidence of premature exposure. IAASB also needs to consider demands for consistency more generally, and distinguish between appropriate flexibility ie, different ways of applying the standard to achieve the desired outcome, and inconsistencies arising from a lack of clarity in the standard itself. The board needs to deal with any lack of clarity in the standard, and not leave it to auditors and audit regulators.

Scalability

6. The proposals, as they stand, are unlikely to be applied to smaller and less complex audits without creating significant confusion and inconsistent application. That, of itself, is a public interest issue and compelling reason to revisit the entire text with the sole aim of rationalisation. This issue is compounded by a lack of clarity about which entities are encompassed by the description ‘smaller and less complex entities’. Our outreach indicates differing interpretations in this area and the fact that such a rudimentary issue was not highlighted and resolved by IAASB, prior to exposure, is particularly worrying.

7. While some of the new material listed in the scalability paragraphs in the Explanatory Memorandum is helpful, and a clear improvement on the extant standard, whether it will in practice, achieve the improvements sought by audit regulators is a moot point. If IAASB is to reduce the risk of the slow abandonment of ISAs for SMEs at a national level, it will need to do more to make this standard genuinely scalable for smaller entities. Scalability for smaller audits is not an ‘implementation issue’. The belief that standard-setters need not concern themselves with smaller audits *per se*, because IAASB’s main customers are the capital markets and because the capital markets are where the public interest lies, is particularly pernicious. We disagree with this approach, which is wrong in principle, and short-sighted. Further guidance and illustrations, outside the standard, produced by IAASB rather than NSS, are essential to ensure consistency of application internationally.

Drafting and navigation

8. We are particularly concerned that the core of ED-315 – the risk assessment process – is exceptionally difficult to navigate without the flowchart. Regardless of whether the flowcharts are included as appendices to the final standard, they are likely to be treated as more authoritative than IAASB intends. If these drafting flaws are not addressed prior to finalisation, improvements to audit quality will be compromised.
9. We would not wish to see this style of drafting repeated in future projects and we urge IAASB to revisit the process by which these proposals were developed. The board needs to consider carefully how these shortcomings in drafting can be avoided in the future. Simply scheduling out comments and dealing with them on a piecemeal basis will not be enough to render these proposals fit for purpose. A more fundamental analysis is required of the extent to which IAASB has actually achieved its objectives in these proposals and, critically, how and why the drafting process itself has failed to produce a workable set of proposals in so many respects.
10. We are particularly disappointed by what appears to be an unnecessary and inappropriate attempt to create a direct link between ISA 315 and FASB definitions used in PCAOB requirements for integrated audits of internal control over financial reporting – definitions not replicated in IFRS. Our objection is not to the proposed alignment with the PCAOB as a matter of principle, far from it. We have in the recent past suggested that IAASB consider more carefully the PCAOB’s position, in relation to auditor reporting, for example. Our objection is to the substance of the proposal, and to the fact that it has been made without adequate explanation or justification: the sole reference to this important change is made in a footnote, which explains only that while there were objections, IAASB decided ‘on balance’ that the two terms ‘reasonably possible’ and ‘more than remote’, were synonymous.
11. To equate ‘a reasonable possibility’ with ‘a more than remote likelihood’ in the context of relevant assertions is simply perverse: it makes little sense to native English speakers, it will make even less sense in translation, resulting in confusion and inconsistent application in a critical area. IAASB should simply remove the words ‘more than a remote likelihood’ from the definition of relevant assertions before finalisation. There is simply no need for these words. If firms wish to justify this equation internally within their methodologies they are free to do so, but it should not be mandated by standards.
12. Some genuine enhancements are proposed, including clarification on the nature of controls relevant to the audit, the new categories of direct and indirect control components, the concept of a spectrum of risk and changes to the definition of a significant risk. Much of this is helpful. The new material on IT issues is important but it would benefit from rationalisation. As it stands it is somewhat muddled.

RESPONSES TO 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 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?***
13. Improvements we support, albeit with some reservations, include the introduction of a spectrum of risk, the updated definition of a significant risk – despite the lack of clarity about whether likelihood, magnitude or both are intended – the differentiation between direct and indirect control components and clarification regarding which controls are relevant to the audit. We also support the references to IT issues in the context of off-the-shelf packages to which entities do not have the source code.
14. We are less convinced by the inherent risk factors which overlap considerably, and by some of the definitions. We note in our major points above that we are unable to construe the equation of a ‘reasonable possibility’ of a material misstatement with one that is ‘more than remote’ as anything other than an attempt to make an unnecessary and wholly inappropriate link between ISA 315 and the FASB definitions used in PCAOB requirements relating to the integrated audit of internal controls over financial reporting.
15. Our main reservations about issues (a) to (c) noted above relate to the overall length and unnecessary complexity of these proposals, which in many respects read more like a large firm methodology than an auditing standard. The definitions of assertions, relevant assertions and significant classes of transactions, account balances and disclosures, and the interaction between these definitions seem unnecessarily convoluted. Absent further guidance from IAASB, there is a significant risk that the proposals will be interpreted inconsistently across jurisdictions and firms. This is a public interest issue.
16. The concept of a spectrum of risk and the new definition of a significant risk are, in principle, improvements, but practice within firms varies. Many firms believe that they already have the former in place in the form of discrete classifications of risk as ‘high, medium or low’, or ‘significant, normal (ie, material) and no risk’, for example. Some firms do not permit a ‘no risk’ classification, and some are moving to a sliding scale. Others again distinguish only between significant risks and other risks. We are concerned that firms will seek to justify the status quo with reference to these proposals, which will result in no change in behaviour and the perpetuation of the different approaches described. Is this really what IAASB intends? The stated objective of these revisions is to improve the quality of risk assessment and to encourage greater consistency. The number and nature of risks identified as significant varies, as does the nature and extent of the work performed on them. While on the face of it, the concept of a spectrum seems sensible, the proposals may have no impact at all. Auditors and audit regulators will need to engage in a more meaningful discussion regarding the application of judgement in this area. Inconsistencies in existing approaches, compounded by novel approaches to the proposed requirements, may actually increase inconsistency in the eyes of audit regulators who should also be aware that a different set of significant risks may be identified using the new definition. The proposals are not clear about whether likelihood, magnitude or both are required for a risk to be assessed as toward the upper end of the spectrum. All IAASB says in the Explanatory Memorandum is that low likelihood but high magnitude risks have not been excluded. We suggest that IAASB make it clear in the application material that this category is potentially very wide and that significant risks in this category are likely to be rare. We have no good quality examples of low likelihood, high magnitude risks that should be assessed as significant *without* taking account of controls.
17. Risk assessments will involve more work, both initially and on an on-going basis, as well as the re-direction of some existing work, but not all of that work will necessarily improve audit quality. Our outreach indicates that some believe that the proposed new requirement for ‘sufficient, appropriate evidence’ to support the risk assessment is unnecessary, circular, and will result in auditors expending resources on documenting why they have not done

something, at the expense of dealing more carefully with the facts supporting the risk assessment. Others think it should be distinguished from the extant requirement relating to audit evidence more generally, by using a construction such as 'appropriate evidence to support', or 'a reasonable basis for', the risk assessment.

18. The circularity referred to above arises from the fact that 'sufficiency' of audit evidence as currently defined is related to obtaining evidence to support the audit opinion. To use the term again in the context of risk assessment is circular. If this requirement is retained, more guidance is needed on its relationship with the extant requirement to obtain audit evidence to support the audit opinion.
19. Data analytics can provide a wealth of information that can be used for different purposes. What is not clear is whether the proposed requirement for risk assessments to be supported by sufficient, appropriate evidence means that where data analytics is used to identify unusual items, and no such items are identified, it would constitute audit evidence to support an unmodified audit opinion as well as evidence to support the risk assessment.
20. The sufficiency of and appropriateness of evidence to support the risk assessment is also relevant to IAASB's upcoming audit evidence project and IAASB should consider removing this proposal pending the outcome of that project. A conforming amendment can be made to ISA 315 at a later stage if necessary.
21. With regard to the flowcharts, we note in our major points above that they are currently the key to understanding the requirements. If a concerted effort is made to rationalise the proposals as suggested above, it may not be necessary to include the flowcharts in the final standard. It would be unfortunate if this standard, of all standards, became known as the one that made little sense without a non-authoritative diagram.
22. It is right that the ISA recognises more clearly the fact that risk assessment is an iterative process. However, documenting such processes clearly and efficiently can be a challenge. From a file review perspective, risk assessment procedures are often not documented or documented poorly. This, combined with an increasing emphasis among regulators on consistency, and on documentation of the application of judgement and professional scepticism, means that IAASB, NSS and audit regulators will need to work together to agree on what a good quality risk assessment looks like, particularly in smaller audits.
23. It is also right to require auditors to have a thorough understanding of the entity's business model. While this may divert some auditors from the financial statements and encourage them to head down 'rabbit holes', it is clear that many corporate failures over the years have been accompanied by a lack of understanding of excessively complex business models. The last significant revision of ISA 315 in 2003 took place against the backdrop of the collapse of Enron and the demise of Arthur Andersen (although the project commenced before these events). One criticism of auditing practice at the time was a perceived overemphasis on the need for auditors to view the business through the eyes of management (ie, a lack of independence). Auditors need to be independent, but they also need to understand how management sees the business.
24. The introductory paragraphs are helpful, although they would probably be unnecessary if the proposed requirements were sufficiently clear. We make a detailed suggestion regarding the wording of proposed paragraph 13 in our answer to Q2 below.

Question2. 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?

25. No. The requirements and application material are not sufficiently scalable to be workable for the audits of smaller and less complex entities. We acknowledge the work that has been performed to enhance the scalability of this document for larger more complex organisations but as they stand, the enhancements made for smaller and less complex audits are inadequate. If IAASB is to prevent the slow abandonment of ISAs for SMEs at a national level, it will need to do a great deal more to make this standard scalable for smaller and less complex entities. We believe this is a public interest issue.

26. Scalability is regarded by too many as an implementation issue to be dealt with by firms, training providers and professional bodies. IAASB's recently approved and long overdue project on the audit of less complex entities will not compensate for a lack of scalability in ISA 315. The belief that increasing audit exemption limits are reason to be less concerned about smaller audits is in some respects a self-fulfilling prophecy. The belief that standard-setters need not concern themselves with such audits, because IAASB's main customers are the world's capital markets and that the capital markets are where the public interest lies, is pernicious. We disagree with this approach which we believe to be wrong in principle and short-sighted.
27. For scalability to be achieved at the smaller end, it is critical that the work required by the revised standard, particularly on controls and IT, eliminates existing redundancies and avoids introducing more. Unfortunately, we are not convinced that either of these objectives has been achieved and we fear that the proposals as they stand will create significant confusion and inconsistent application for smaller audits. We urge IAASB to consider these areas again before finalisation. We make more detailed points on these issues in our answer to Q5 below.
28. Further guidance and illustrations, outside the standard, produced by IAASB rather than NSS, are essential to ensure that the standard itself is sound and is consistently applied internationally. If this is left to NSS, the inconsistencies that will inevitably arise will highlight, all too soon, flaws in the standard itself. This would be a highly undesirable outcome and would further compromise the credibility of IAASB as the global auditing standard-setter for SMEs.
29. Specifically, more guidance and examples are needed for smaller and less complex audits in the areas of:
- the nature and extent of work on the design and implementation of controls in primarily substantive audits (paragraphs 39-42) and on IT systems, control components and system generated reports more generally;
 - evaluating where a risk lies on the spectrum of risk;
 - documentation, particularly in terms of the two points above, and in terms of understanding the business model, the control environment (paragraphs 27 and 28), the entity's risk assessment process (paragraphs 29-31) and its process to monitor controls (paragraphs 31-34).
30. Putting aside the detailed improvements proposed regarding smaller and less complex audits, overall, this standard will require more work and increase costs on all audits. To the extent that this will change behaviour and result in better quality and more consistent risk assessments, this is justifiable. But for many audits it seems likely that because of the level of methodological complexity introduced, such improvements will be hard to discern. It also seems possible that the proposals might actually detract from audit quality in some cases, as a result of too much time spent on navigating the standard, and too little on the significant audit issues. While it is possible to take the view that firms who struggle this way need to consider whether they should be performing audits at all, it is also possible to take the alternative view that the extant standard is not really fit for purpose for smaller audits, and that the proposals simply make the situation worse. This line of thinking is one of several underlying IAASB's project on the audit of less complex entities. We welcome that project but ISA 315 needs to work for smaller audits now. Scalability for smaller audits cannot simply be offloaded in the hope that the new project will deal it. Once this ISA is finalised, it will be too late.
31. Paragraph 13 refers to considerations specific to 'smaller entities which are also less complex', which is unambiguous in plain English. This terminology should be used throughout, rather than the phrase 'smaller and less complex entities', because the latter construction is ambiguous and begs the question as to whether the two characteristics apply independently of each other, which is not the intention. While we agree that some larger entity audits may be less complex, we do not think it is helpful to state that the relevant considerations may also apply in such cases. All of that said, we note some opposition in our outreach to the notion that the relevant considerations should be limited to less complex

smaller entities, and a belief that they can and should apply to less complex entities of any size. We also note (a) a lack of clarity arising from the ISA 200 definition of smaller entities which already includes the characteristic of uncomplicated operations, and (b) IAASB's recently approved project on the audit of 'less complex entities', but not necessarily smaller ones. Taken together, rightly or wrongly, it is hard to avoid an unfortunate impression that IAASB is simply unwilling or unable to grasp the nettle of smaller audits *per se*.

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?

32. The manner in which IAASB has dealt with automated tools and techniques is adequate, but only just. Our outreach indicates that respondents had expected considerably more in this space given that data analytics are currently used principally in the risk assessment. Nevertheless, we look forward to the discussions concerning data analytics in IAASB's forthcoming audit evidence project.

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'¹ 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?

33. Our outreach did not elicit any suggestion that the proposals would have a marked effect on the exercise of professional scepticism. The promotion of scepticism is a complex, largely behavioural issue in which auditing standards probably play a relatively minor role and IAASB should be careful not to raise expectations inappropriately in this area. Significantly, few commentators believed that the proposed new stand-back or the existing stand-back in ISA 330 was likely to have much impact: the existing stand-back results in audit work for the sake of it in many cases, and neither the extant nor the proposed stand-back should be necessary if the risk assessment has been performed properly in the first place. We make more detailed observations on this issue in our answer to Q8 below.

34. We note in our answer to Q1 above, that our outreach highlighted a belief that the proposed new requirement for 'sufficient, appropriate evidence' to support the risk assessment, is unnecessary and circular. It will result in auditors expending resources on documenting why they have not done something. Others think it should be distinguished from the extant requirement relating to audit evidence more generally by using a construction such as 'appropriate evidence to support', or 'a reasonable basis for', the risk assessment.

35. References to the need to deal appropriately with inconsistent and contradictory information (such as paragraphs A19 and A44) represent progress, but there is no requirement covering this. We note with interest the discussion on the issue in the context of ISA 540 on estimates, and we look forward to further consideration of this issue in IAASB's forthcoming audit evidence project.

RESPONSES TO SPECIFIC QUESTIONS

Question 5. Do the proposals made relating to the auditor's understanding of the entity's system of internal control² assist with understanding the nature and extent of the work

¹ See paragraph 27 of this Explanatory Memorandum and paragraph 17 of ED-315

² Paragraphs 25–44 and A89–A200 of ED-315

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?**

36. **The rationale for understanding internal control:** the reason given in paragraph 31 of the Explanatory Memorandum for requiring an understanding of internal control includes the following wording:

'In particular, the understanding informs the auditor's expectations about the operating effectiveness of controls and the auditor's intentions to test controls.'

If IAASB wishes to change the behaviour of auditors who do not believe that they should have to take any account of controls when performing what are (sometimes erroneously) described as 'fully substantive' audits, it needs to be clearer than it is at present about the fact that understanding internal control is an integral part of understanding the entity and identifying and assessing the risk of material misstatement. Controls only exist to mitigate perceived risks and understanding the existence and quality of controls – regardless of whether this is by means of work on design and implementation or by other means - constitutes important evidence about how the entity understands and manages risk. This is the primary reason for understanding internal control. It is not, as described in paragraph 31, simply to decide whether or not to test the operational effectiveness of controls and to inform expectations about their effectiveness.

37. The idea that control risk is irrelevant to the audit risk model in fully substantive audits is not based on the idea that controls are irrelevant, but that control *risk* is only relevant if the operational effectiveness of controls is to be tested. It makes no sense to require auditors to assess control risk as maximum if control risk is irrelevant. IAASB should make a stronger link between the need to understand controls in order to understand the business and the risks management believes it is mitigating using those controls.
38. In this context, the flowchart dealing with understanding the entity's internal control is much clearer than the words. Towards the bottom right, the chart refers to design and implementation work on controls (paragraph 42) and suggests that problems identified through design and implementation work might lead to the identification of risks of material misstatement at the assertion level ('the output contributes to the risk of material misstatement at the assertion level'). This seems sensible: if walkthrough tests suggest problems, the risk assessment and/or the nature and extent of substantive testing should change in response.
39. The purpose of work on controls is to enhance the understanding of the risk of material misstatement, which the flowchart seems to allow for, but the wording of the relevant paragraphs in the ISA is much less clear. The assumption seem to be that testing the operational effectiveness of controls is the default position. Auditors of many smaller entities, and auditors making extensive use of sophisticated data analytics techniques in some larger and more complex audits, might challenge this assumption. A controls-based audit approach is far from the norm in audits of any size and data analytics and other automated tools and techniques may eventually render it redundant.
40. It seems that for some audits, work on understanding controls, including design and implementation work, is perceived as having value both for the audit, and for the audited entity. Our outreach indicates strongly that one important reason for performing work on internal control that the ISA could emphasise more is the fact that in audits of all sizes auditors rely on system-generated reports inappropriately. Where controls are considered, the focus is often on high level general controls rather than on the specific IT controls over the reports on which the audit work is performed, or over journal entries, for example. Audit regulators comment on this in their inspections of audits of all sizes. This is brought out in application material but it warrants further elaboration and an example, perhaps involving

analytical procedures performed on a receivables listing. This might refer to the work that would need to be performed on the listing in a simple situation to provide evidence regarding its integrity in terms of completeness and accuracy – before the analytical procedures are performed – without any reference to internal controls over the production of the listing.

41. In other audits, it seems that work on controls is perceived as having less value. Our outreach indicates that the audit work performed on controls in some cases varies little, regardless of the quality of the entity's controls, rendering that work largely redundant. Once again, this issue is not restricted to the audits of smaller entities. The problem is that neither the extant standard nor the proposals make any attempt to acknowledge these issues. Even some larger firms are moving away from testing controls, and from performing analytical procedures, towards more extensive tests of detail. If this trend is accelerated by advances in the use of data analytics, some of the detailed new material on controls and IT may become redundant in a relatively short period of time. We therefore urge IAASB to consider whether some of the new material on IT might be moved to separate appendices, particularly given that much of it is only relevant to larger audits, and much of it is untested.
42. IAASB should not defer consideration of the fundamental issues regarding the nature and extent of work needed to understand controls where the operational effectiveness of controls is not tested, and a fully substantive audit approach is taken. There is a body of opinion among practitioners that strongly believes that for some such audits – and not just smaller audits – the work required by the extant standard on the design and implementation of internal controls is inappropriate because it is predicated on the implicit assumption that controls will in fact normally be tested for operational effectiveness. Other approaches to the necessary understanding of controls are possible and we urge IAASB to consider this issue in finalising this standard, and not to defer it. The issue is too important and too urgent to be left to the project on the audit of less complex entities.
43. **Direct and indirect control components:** the introduction of the notion of direct and indirect control components and their relationship with risks at the financial statement and assertion levels is helpful. As application material, it represents the approach taken in many audit methodologies and will thereby clarify best practice. Our outreach indicates that even so, this is an important development and that more guidance is needed to prevent misunderstanding. To some, this will appear to be just another area of new terminology.
44. **Control environment:** there is an increased focus on corporate governance and consequently on understanding the control environment. While guidance for the audit of those many smaller entities in which the control environment is informal has been enhanced, it remains limited. Where a fully substantive audit approach is taken, it is hard to gauge the extent and depth of work required on the control environment.
45. **Control activities:** there is no clear distinction between controls within the control activities component and controls in the other components, particularly the information system and communications component. This seems to diverge from the COSO model and the explanation that controls in the control activities component are controls 'over' the flows of information and the financial reporting processes is weak and unclear. We do not understand why these changes have been proposed.

b) *Have the requirements related to the auditor's identification of controls relevant to the audit³ 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?*

46. The listing of controls relevant to the audit in the application material is helpful. The question that arises repeatedly in this context is whether there are any situations in which there are no controls relevant to the audit. It has been suggested during recent IAASB webinars on ISA 315 that the answer to this question is no, because controls over journal entries are always relevant to the audit. This answer is presumably based on the assumption that all audited entities use journal entries in preparing the financial statements. We have heard

³ ED-315, paragraphs 39–40 and paragraphs 37–40 of this Explanatory Memorandum

suggestions to the effect that this is not always the case. This is an important issue that should be dealt with in the standard itself and we therefore suggest that IAASB should acknowledge explicitly in paragraph A167 that in some cases, there may be no controls relevant to the audit but that in the overwhelming majority of cases, there will be controls over journal entries. Where such controls exist, they are always relevant. More importantly, the standard should acknowledge that even if there are no controls relevant to the audit, auditors will always need to **understand** the components of internal control in more general terms in order to understand the business and assess risk.

47. More guidance is needed to unpack paragraph A166 which is critical to understanding the distinction between direct and indirect controls and refers to important scalability issues. The language used in this paragraph is awkward at best. Clear and understandable examples of specific direct and indirect controls in a simple situation are needed to bring this paragraph to life.
48. Paragraph 39 (e) is critical. The subjectivity involved in determining which controls 'are appropriate to evaluate their design and determine whether they have been implemented' (a clumsy construction at best, one that is only just comprehensible in plain English) already leads to inconsistencies in practice. Two audit teams provided with identical facts, this paragraph and the associated guidance in paragraph A179, would unlikely arrive at the same place. Absent further guidance, this is a missed opportunity to encourage greater consistency in the determination of controls relevant to the audit. Of all of the controls relevant to the audit listed in paragraph 39, 39 (e) is the most important, and has the least application material associated with it. Application material should address how such controls should be identified, and the factors influencing the auditor's judgement in determining whether it is appropriate to evaluate their design and implementation. As a scalability issue, it would help greatly if there were specific acknowledgement of the fact that in smaller less complex audits in which a fully substantive approach is taken, there may be few, if any controls falling into this category.
49. It would help if there were some reference in the application material to situations in which smaller entities outsource the preparation of financial statements to third parties, including accountants, and the effect this has on understanding the information and communication component. Our outreach indicates that some practitioners have read the proposals as implicitly requiring service organisation reports relating to those third parties in such cases, which we do not believe is or should be the intention.

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?

50. The new IT related concepts and definitions are welcome, although we note in our answer to Q5 above, concerns about the inclusion of this volume of detail in the main body of the standard (rather than an appendix) given long-term trends away from controls testing, even in larger audits. This concern is compounded by terminology in this area not being standardised, and the material being untested. The helpful material relating to situations in which the entity uses an off-the-shelf accounting package with limited or no modifications needs to be given more prominence and, in particular, it needs to be brought to the **beginning** of the section entitled **Understanding the entity's use of IT**, together with paragraph A150 on larger and more complex entities. This is important to avoid creating the impression that smaller firms need to routinely perform a detailed critical analysis of widely used accounting software packages. However, this needs to be balanced with an acknowledgement that in many cases there may well be some risks arising from IT, even though such risks may be low. The material should acknowledge that while the use of off-the-shelf packages does indeed eliminate some risks, other basic controls may be important, including those relating to the physical security of data, and simple controls over the

customisation of reports, such as the reporting parameters for receivables listings. In such cases, there may be few IT general controls relevant to the audit and the material on IT general controls, including the material in appendix 4, may be of limited relevance.

51. IAASB should in the application material distinguish between limited modification – and note that limited modifications may be significant – and no modification, and note that management may not always be aware that modifications have in fact been made.
52. The statement in the Explanatory Memorandum to the effect that the IAASB is of the view that it is unnecessary for auditors to identify risks arising from the use of IT or IT general controls unless there are IT applications that are relevant to the audit, is helpful. However, over-reliance on untested IT general controls and a lack of understanding of the IT environment remains a widespread cause for concern among regulators and we welcome the enhanced focus on this area, despite the over-engineering.

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’?⁴

53. We support the separate assessments of inherent and control risk at the assertion level, as this reflects common practice. It also represents what providers of audit software and methodologies to smaller firms seek to encourage users to do.

b) Do you support the introduction of the concepts and definitions of ‘inherent risk factors’⁵ 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?

54. While we broadly support the concept of inherent risk factors which will structure thinking when identifying and assessing risk at the assertion level, we are concerned about the level of overlap between the factors listed, and the inclusion of susceptibility to fraud among them. Furthermore, we do not believe that they will change behaviour significantly or, of themselves, result in significantly enhanced risk assessments. Auditor experience and audit firm culture are much more likely to have an impact on the quality of risk assessment. The proposals might usefully emphasise the fact that inherent risk factors are flexible, and are a way to help auditors identify and assess the risk. They should not become an exercise in putting the risks into the right categories.
55. We believe IAASB should re-consider the need for susceptibility to fraud as an inherent risk factor for three reasons: overlap with ISA 240 and the likelihood of inconsistency as a result, the need to reduce the level of over-engineering generally, and the risk of increasing the expectation gap. We believe that this factor is most likely to be questioned by respondents and that IAASB should therefore give serious consideration as to the need for it and, in the light of the observations above, whether it will in fact change behaviour.
56. We also believe that more clarity is needed on the ‘quantitative’ aspect of risk factors. The ‘IRFs’ were originally ‘QUIRFs’ and the rationale for the Board’s move from ‘qualitative’ to ‘qualitative and quantitative’ risk factors is not altogether clear.

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?

⁴ Paragraphs 45–50 and A201–A235 of ED-315

⁵ See paragraph 48 of this Explanatory Memorandum and paragraphs 16(f), A5–A6 and A83–A88 of ED-315

57. To an extent, the introduction of the concept of the ‘spectrum of inherent risk’ reflects and codifies what actually happens in an inherent risk identification and assessment exercise. This of itself is beneficial and the codification represents an improvement on the extant ISA. However, we doubt that it will achieve greater consistency in the identification and assessment of risk, including significant risks.
58. We note in our response to Q1 above, that many firms believe that they already have a spectrum of risk in place in the form of discrete classifications of risk as high, medium or low, or significant, normal (ie, material) and no risk, for example. While on the face of it the new concept seems sensible, many firms will justify their existing approach with reference to it and as a result, there may be little change in behaviour, no reduction in inconsistent risk assessments and no improved risk assessments. This is a public interest issue. Auditors and audit regulators will need to engage in a more meaningful discussion regarding the application of judgement in this area. Inconsistencies in existing approaches, compounded by novel approaches to the proposed requirements, may actually increase inconsistencies in the eyes of audit regulators who should also be aware that a different set of significant risks may be identified using the new definition. In particular, some risks currently caught may not meet the revised definition, depending on how the proposals are interpreted.
59. If IAASB wishes to improve practice in this area it needs to better articulate, or provide examples of, how auditors might weigh the inherent risk factors when assessing the many risks that fall into the highly populated ‘grey’ area in the middle of the spectrum. One way of achieving this might be to provide examples of contrasting situations in which an apparently similar risk might be assessed as being at the lower, middle and upper ends of the spectrum, depending on specified circumstances. While the response to the risk assessment is outside the scope of this revision, we believe that considering the response in such contrasting situations would provide useful insights.

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 (ie, an assertion is relevant when there is a reasonable possibility of occurrence of a misstatement that is material with respect to that assertion),⁶ and how they assist the auditor in identifying where risks of material misstatement exist?

60. We broadly support the notion of ‘relevant assertions’, although we believe that the related definitions and articulation of these and of the ‘significant classes of transactions, account balance and disclosure’ are laboured in the extreme. IAASB should seek to rationalise these concepts before finalisation. The proposed paragraph 52 stand-back requirement might suggest that the concept of a ‘significant’ assertion is redundant. Why not simply refer to ‘material’ classes, throughout?
61. ‘Relevant assertions’ if used properly should contribute to a more focused risk assessment at the assertion level. However, our outreach indicates universal disagreement with the notion that ‘reasonably possible’ can or should be equated with ‘more than remote’. This equation makes little sense in plain English and will result in inconsistent application, particularly in translation. It is impossible to construe this odd articulation as anything other than a completely unnecessary and wholly inappropriate attempt to create a direct link between ISA 315 and FASB definitions used in PCAOB requirements for integrated audits of internal control over financial reporting – definitions not replicated in IFRS. Our objection is not to proposals being aligned with those of the PCAOB as a matter of principle, it is to the substance of the proposal, and to the fact that it has been made without adequate explanation or justification: the sole reference to this important change is made in a footnote, which explains only that while there were objections, IAASB decided ‘on balance’ that the two terms ‘reasonably possible’ and ‘more than remote’, were synonymous.

⁶ See footnote 26 of this Explanatory Memorandum

62. We strongly suggest that IAASB simply removes the words ‘more than a remote likelihood’ before finalisation. It is unnecessary and serves only as a distractor. If firms wish to justify this equation internally within their methodologies they are free to do so, but it should not be mandated by standards.
63. The terms ‘probable’, ‘possible’ and ‘remote’ are distinct and widely used terms within financial reporting and we see no reason to use different terminology. Specifically, ‘possible’ and ‘remote’ (even when the former is ‘more than’ the latter) do not sit well together. ‘Possible’ is closer to ‘more than remote’ than ‘reasonably possible’ but we doubt IAASB would be willing to abandon the term ‘reasonably’, and we therefore suggest that ‘reasonably possible’ be left as it is. There is no need for further elaboration.

e) Do you support the revised definition,⁷ 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?

64. The proposed definition of ‘significant risk’ is an improvement on the extant definition which leads to inconsistencies in practice. It should be easier to apply, but audit regulators should be aware that a different set of significant risks may be identified using this definition. We note in our answer to part (c) of this question that some risks currently caught may not meet the revised definition, depending on how the proposals are interpreted. The Explanatory Memorandum notes that risks with high magnitude but low likelihood are not excluded, but the lack of clarity in the standard itself is bound to lead to inconsistencies. IAASB needs to be explicit: are both conditions required for a risk to be caught, or just one? We are aware of different interpretations of IAASB’s assumed intent.

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,⁸ including the determination about how, and the degree to which, such risks may affect the assessment of risks at the assertion level?

65. The additional guidance relating to determining financial statement level risk needs more work. The reference in proposed paragraph 47 to ‘the degree to which’ such a risk may affect risk at the assertion level is somewhat circular, as well as being problematic in other respects. It is not clear, for example, how auditors can assess ‘the degree to which’ a common financial statement level risk – going concern – affects risks at the assertion level. Doubts about the going concern status of an entity affect valuation and disclosure at the assertion level but these are assertions *per se*, not risks at the assertion level. Documentation of this assessment is likely to be subjective and inconsistent.

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?

66. Our outreach indicates that there is a strong body of opinion to the effect that there is no need for either paragraph 52 in proposed ISA 315 or paragraph 18 in ISA 330, and certainly not both. The latter often results in ‘notional’ substantive procedures being performed for compliance purposes only and rarely if ever, catches items that have somehow fallen through the net. The proposed standard is clear that the requirements are intended to be iterative and there should be no need for yet another safety net. A requirement in ISA 330 to perform substantive procedures on a material balance anyway, renders the proposed requirement to re-determine what is significant in paragraph 52 of ISA 315 redundant in the eyes of some. Both requirements undermine the risk-based and iterative nature of risk assessment and both are inadequate to the extent that neither deals with completeness or

⁷ Paragraphs 16(k) and A10, and A229–A231, of ED-315

⁸ ED-315, paragraphs 47 and A215–A220

understatement, both of which are very common lacunae. If either is needed, on the face of it, ISA 315 seems the right place for a requirement; proposed paragraph 52 should be retained, and paragraph 18 of ISA 330 removed.

67. However, concerns have also been expressed that because of the different approaches to risk assessment described in our answer to Q1 above, without the extant ISA 330 stand-back, auditors might in some cases do no work on a material item on the basis that there is no risk of material misstatement, and that paragraph 18 should therefore be retained. The issue in hand is not necessarily the stand-back, but whether the proposed spectrum of risk is intended to permit an assessment of **no** risk of material misstatement where a class of transactions, account balance or disclosure is material. These issues warrant further consideration prior to finalisation.
68. The use of the terms 'quantitatively or qualitatively' in the context of material is similarly wholly unnecessary as materiality by definition always has (at least potentially) both aspects.

Conforming and Consequential Amendments

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

a) ISA 200⁹ and ISA 240, are these appropriate to reflect the corresponding changes made in ISA 315 (Revised)?

69. We note in our answer to Q6 above, our concerns about including susceptibility to the risk of fraud as an inherent risk factor. IAASB is proposing fairly minor amendments to ISA 240 and we remain unclear as to why it seems necessary to include considerations relating to the susceptibility to fraud in the context of risk assessment in two ISAs.
70. We have no comment on the proposed amendments to ISA 200.

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

71. We note in our answer to Q8 above, the fact that we do not believe that references to the 'qualitative and quantitative' nature of materiality are necessary because materiality, by definition, incorporates both aspects. To include such references implies that there may be situations in which auditors might consider one aspect but not the other, and we do not believe that such a situation would ever arise. We therefore strongly suggest that references to the qualitative and quantitative nature of materiality are removed from paragraphs 18, A4 and A42 of ISA 330.
72. We note in our answer to Q5(c) above, the importance of IT general controls relevant to the audit, the need for greater emphasis on situations in which the entity uses off-the-shelf software and has no access to the source code, and the fact that there will be a limited number of basic IT general controls relevant to the audit in such cases. This point could be made in ISA 330 as well as ISA 315.

c) The other ISAs as presented in Appendix 2, are these appropriate and complete?

73. We note the large number of conforming amendments in this appendix but we have no specific comments on them.

d) ISA 540 (Revised) and related conforming amendments (as presented in the Supplement to this exposure draft),¹⁰ are these appropriate and complete?

74. We have no comment on the proposed amendments to ISA 540.

⁹ Conforming amendments to ISA 200, paragraph A42 will be presented with the conforming amendments to ISA 540 (Revised)

¹⁰ Published in late July 2018

Q10: 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?

75. As noted in response to Q8 above, we do not support the use of the terms ‘quantitatively or qualitatively’ in the context of materiality. By definition, it covers both aspects.

Request for General Comments

Q11: 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.

76. IAASB is often informed that the translation of terms such as ‘significant’, that have a specific meaning in the context of ISAs, is sometimes problematic. In some languages the word ‘significant’ may be translated using the same word or words as those used for ‘material’, for example. It seems likely that in this case, nuanced distinctions may give translators pause for thought when considering existing translations of similar terms in other ISAs, as well as the one in hand. Native English speakers will struggle with some of the definitions and distinctions and new terms always create a multiplicity of interpretations. We noted in our outreach differing interpretations of the word ‘spectrum’, for example.

77. The fact that IAASB has had to ask question 11 at all demonstrates the dangers associated with the use of words with a similar meaning in close proximity. This sort of over-engineering will not only cause problems for translators, but will almost inevitably result in inconsistent understanding and application of the standard across firms and jurisdictions, making the existing problem worse.

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 period to support effective implementation of the ISA.

78. We note in our major points above our concern that IAASB appears to have seen fit to expose these proposals prematurely, and that we are not convinced that ED-315 can be rendered fit for approval without re-exposure. The proposed timetable for finalisation post-exposure for such an important ISA was aggressive to begin with and companies and auditors globally will live with the adverse consequences of excessive haste for many years to come. We strongly urge IAASB to take the time necessary to get this linch-pin ISA right, in the public interest.

79. We note in our major points above our belief that IAASB should revisit the process by which these proposals were developed and consider carefully how the shortcomings in drafting can be avoided in the future. We suggest that scheduling out comments and dealing with them on a piecemeal basis will not be enough to render these proposals fit for purpose, and that more fundamental analysis is required of the extent to which IAASB has actually achieved its objectives in these proposals.

80. Whether an appropriate effective date is for financial reporting periods beginning 18 months after the approval of a final ISA depends on when in the year approval takes place. If the final standard is approved in, say, June and the effective date is for audits of financial statements for periods beginning on or after December 15 the following year, training can take place in Northern Hemisphere jurisdictions such as the UK in the summer of the following year, and software and methodology providers will have approximately 9 months to perform the necessary re-writes in order to facilitate that training. If approval slips beyond June, IAASB should re-consider the effective date as the summer training window cannot easily be

extended. We expect that IAASB will publish the final document in draft form (and not wait for PIOB approval) as it has for ISA 540 to facilitate adoption processes at a national level.