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1 November 2018

Mr. Dan Montgomery
Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
585 Fifth Avenue – 14th Floor
New York, NY 10017
U.S.A.

Re: IAASB Exposure Draft: *Proposed ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement*

Dear Mr. Montgomery

BDO International Limited[1] (BDO) is pleased to have the opportunity to comment on the International Auditing and Assurance Standards Board (IAASB) 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*.

We also welcome the extent of outreach efforts undertaken by the IAASB through use of conference calls, webinars and presentations (for example, those provided to the Forum of Firms and Transnational Auditors Committee) and other engagement with BDO colleagues. Having the ISA 315 Task Force Chair and IFAC Staff engage with practitioners at the pre-Exposure Draft and post-Exposure Draft stages of the standards development process has enabled potential respondents to think through the multiple issues contained within ISA 315 (Revised) Exposure Draft (ED-315) and has also helped us canvass and collate views from across our global organisation.

While we are supportive of the significant proportion of the new concepts in the Exposure Draft, as well as much of the application guidance, there is one area within ED-315 that, in our view, requires further consideration and improvement, as described below.

<u>Design and implementation of controls when control risk is set at maximum</u>

We have significant concerns regarding the requirement to assess design and implementation (D&I) of controls relevant to the audit and information system controls relevant to financial reporting in situations where the auditor does not plan to take reliance from those controls (i.e. the auditor plans to set control risk at maximum and perform a fully substantive audit). We do not object to the auditor <u>obtaining an understanding</u> of these aforementioned controls, but we do not see the value in <u>assessing the D&I of those controls</u> when the auditor is planning a fully substantive audit. ED-315 does recognise that control risk should be set at maximum when the auditor does not plan to test operating effectiveness of controls;

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we think ED-315 should go further and state that it is not necessary to assess D&I of controls relevant to the audit or information system controls relevant to financial reporting when control risk is set at maximum.

We acknowledge that it is necessary to obtain an understanding of these controls for the purpose of identifying and assessing the potential risks of material misstatement at the financial statement level and the assertion level (paragraphs A89, A102). However, we do not see any rationale in ED-315 for requiring an assessment of the D&I of those controls.

For smaller non-complex entities, we believe that obtaining an understanding of those controls is sufficient for identifying risks and often for determining that testing operating effectiveness of controls is not a viable testing strategy option. On these engagements, practitioners believe there is minimal value to this D&I work effort or documentation; it has no impact on the audit strategy and provides no additional value to the entity nor to the public interest. In our opinion, assessing D&I in these situations would not improve quality on these smaller non-complex audits.

Therefore, we believe that this is an important issue that should be addressed in ED-315, particularly given the proliferation of smaller non-complex audits in many jurisdictions. We understand that the IAASB has another project to look at auditing standards for small entities, but given how central ISA 315 is to the audit process and the audit methodologies of firms, we feel strongly that at a minimum, ED-315 should reflect the feedback from auditors of small entities regarding the lack of value in assessing D&I of controls when control risk is set at maximum.

We believe ED-315 is a key standard from a public interest and audit quality perspective and therefore the IAASB needs to get it 'right', both for public interest entities and smaller non-complex entities. Neither the public nor the audit profession will be well served by rushing to issue this standard.

Request for Comments

Respondents are asked to comment on the clarity, understandability and practicality of application of the requirements and related application material of ED-315. In this regard, comments will be most helpful if they are identified with specific aspects of ED-315 and include the reasons for any concern about clarity, understandability and practicality of application, along with suggestions for improvement.

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)?

We believe that most of the standard has been appropriately structured and clarified and that the revisions are responsive to some of the practice issues identified, inspection findings, and responses from various stakeholders.

However, as outlined in our overall comments and our responses to the specific questions below, we

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do have some concerns related to scalability (particularly the requirement to assess design and implementation of controls relevant to the audit when control risk is set at maximum), and understandability (i.e. the overall complexity and length of the standard, use of the term 'risk of material misstatement' in different contexts, the requirement to obtain sufficient appropriate audit evidence regarding risk identification and assessment, the definition of relevant assertions, confusion over the need to assess design and implementation of information system controls relevant to financial reporting, and the stand-back requirement).

Notwithstanding the efforts of the IAASB to improve and clarify ED-315, there is a danger that the volume of content – at nearly 300 paragraphs spanning 80 pages – has the potential to make this ISA practically unwieldly and confusing for users. There is also an implicit risk that by being so prescriptive, this ISA has moved away from being a principles-based set of requirements, to one that tries to define a step by step audit methodology.

We note that the flowcharts reflect the iterative nature of the standard and are representative of the requirements. However, the complexity of the flowcharts illustrates very clearly the complexity of the requirements and that the standard may not be practical, particularly for smaller non-complex entities.

In addition, in the Understanding Internal Control flowchart, we believe that the step to identify controls relevant to the audit comes too early in the process when the flowchart is used in a linear manner by practitioners. It is currently in the section to obtain an understanding the entity's system of internal control, which is prior to the step of identifying risks in the corresponding risk assessment flowchart. Given that the definition of controls relevant to the audit includes controls over significant risks, it doesn't make sense to identify controls relevant to the audit before risks are identified, let alone assessed as significant. We suggest that the step to identify controls relevant to the audit be moved after the step to identify risks. Further, this flowchart does not address whether the entity's control environment and/or risk assessment process affect the risk of material misstatement. We believe there is also a need for some clarification in the linkage between the risk assessment flowchart and the obtaining an understanding of the entity's system of internal control flowchart.

A general comment on the flowcharts is that they do not distinguish between actions / decisions and objects / outputs. Most flowcharts use different shapes to represent actions / decisions so that the flow of the process is more obvious. For example, we note that in the risk assessment flowchart, the section on identifying risks results in several outputs. We suggest that different shapes be used to distinguish actions from outputs.

Please note that we have provided an appendix at the end of this response letter that summarises minor suggested edits to various paragraphs in ED-315.

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?

ED-315 has the potential to result in a more robust risk identification and assessment process, if users are not overwhelmed by the complexity of the requirements and the length of the application

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guidance. We do agree that a number of the changes should help address the public interest issues, for example, the guidance on understanding IT and the modernisation of the standard to allow for automated tools and techniques. We also agree with the guidance added on professional skepticism at relevant points in the standard.

Regarding identification of potential risks of material misstatement, ED-315 is not clear on the auditor's responsibility regarding the identification and assessment of business risks identified by the entity that may result in a potential risk of material misstatement. We believe that ED-315 should provide clearer direction to the auditor regarding their responsibility to consider business risks that could impact the financial statements when identifying potential risks of material misstatement. This concept exists in ISA 200 paragraph A40 but it should be emphasized in ED-315 as well.

c. Are the new introductory paragraphs helpful?

The new introductory paragraphs describe key concepts in the standard. It is not clear what the status of these key concepts is as these are described in the introductory paragraphs instead of in the requirements paragraphs.

We note that the introductory paragraphs include concepts that are further developed later in the standard which may lead to misinterpretation and inconsistent application. For example, paragraph 4 states that the 'identification of risks of material misstatement is performed before the consideration of any controls' which seems to be the definition of inherent risk. Paragraphs 5 and 7 then refer to the assessment of risks of material misstatement being based on the auditor's assessments of inherent risk and control risk. Further, paragraph 9 then refers to 'potential risks of material misstatement' as a general concept in the risk assessment process. The inconsistent use of the term 'risk of material misstatement' in the introductory paragraphs and throughout the standard could lead to incorrect application when implementing the standard. We recommend that the standard use the term 'potential risks of material misstatement' as a general term during the risk identification stage and the term 'risk of material misstatement' during the risk assessment stage which encompasses assessments of inherent and control risks. When referring to 'risks of material misstatement without consideration of controls', we suggest that the term 'inherent risk' be used instead.

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

We believe that ED-315 is significantly improved through the additional examples and guidance provided, and it will assist auditors with applying the requirements to entities of various sizes and complexities. We do have concerns that some of the requirements may be overly complicated and possibly onerous to apply to very small entities. In our response to question 5, and in our overall comments at the beginning, we have raised our concern about the extent of work and documentation related to assessing design and implementation of controls when the auditor plans a purely substantive audit and has no intention of relying on controls either because they are ineffective, or they are non-existent.

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We suspect that parts of the flowcharts provided with the ED have blurred the understanding given by the text in the requirements. Furthermore, the need for flowcharts to interpret the requirement paragraphs indicate that the standard may be too long and overly complicated, making it difficult for auditors to interpret, which will lead to inconsistencies in application.

We also think that further clarification around the extent of documentation required to demonstrate our understanding of controls and assessments of design and implementation (if required) in smaller non-complex entities with ineffective or non-existent controls would be beneficial. For example, if the auditor has determined that a fully substantive approach to the audit will be taken, guidance on the minimum documentation to satisfy the requirements around controls, specifically those in paragraphs 38, 39 and 42, would be helpful. Excessive documentation on something with little impact on the audit is a threat to audit quality as it moves resources away from focusing on the important risks on the engagement.

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?

Yes, on balance we are supportive of the approach adopted by the IAASB to use the term 'automated tools and techniques' as a means of modernising the ISA to reflect increasing use of technologies in a continually evolving environment. This explicit reference is a step in the right direction (moving the ISAs away from the current position of not expressly prohibiting use of technologies while also not promoting them either).

We agree that making reference to the concept of audit data analytics only would have been unnecessarily restrictive and may have limited the use of emerging technologies (artificial intelligence, bots, drones, etc.).

The term and usage of automated tools and techniques provides flexibility within the Exposure Draft:

- To enable auditors to make use of new and emerging technologies as part of the risk assessment procedures, and

- Not to prescribe it (as a requirement) when auditors may not have these resources available to them or the audit work may be best performed through non-technology procedures.

The approach adopted by the IAASB takes into the account the increasing pace of technological change, varying levels of investment or areas of technology focus by audit firms and the efforts they are taking within the profession to help improve audit quality and audit efficiency (as well as providing improvement recommendations provided to audit clients) through increased use of technology. As a result, we support the use of examples within the Application and Other Explanatory Materials as a means to convey the potential use of these technology solutions without being unnecessarily prescriptive or restrictive.

We support the amendment to A15 to highlight the potential for using technology on large volumes of data which can enable auditors to examine a full dataset in order to look for: (i) information to support risk identification and assessment and (ii) recurrence of data anomalies or exceptions which may also help auditors identify potential RMMs as being remote or not. Acknowledging the potential use of automated tools and techniques as part of A18 also helps to provide reassurance, and potentially some encouragement, for auditors to consider how they can use alternative technology-led approaches to perform risk assessment procedures.

The specific examples in A33 (extracting data from an entity's information system and analysing this data through use of visualisation techniques), A48 (using technology to understand the flows of transactions and processing as part of understanding the Information System) and A175 (automated procedures to analyse full population of journal entries, including personnel and authorisation) are simple, yet practical examples of how technology could be used by auditors as part of risk assessment procedures. The way in which these examples have been presented also does not appear to restrict future innovation as technologies continue to develop and auditors identify additional steps that can be undertaken using other (automated) tools and techniques, including tools for the assessment of soft controls for example.

An area where the IAASB may need to consider the provision of further implementation support (whether as guidance or staff papers) is when technologies are initially being used for risk assessment purposes and through continual refinement of data or improved understanding of the data, change into becoming a procedure that has the potential to generate audit evidence (perhaps through modification of the initial risk assessment procedure itself). Such guidance would emphasise a much more iterative audit approach and would help to remove the distinction between the planning and execution phases of the audit. Also, as we note in our responses to Questions 8 and 10 below, we take the view that the IAASB's revision of ISA 315 should seek to remove unnecessary or potentially duplicative requirements (such as paragraph 18 in ISA 330) to reflect how increasing use of automated tools and techniques and being able to 'see' entity data through a digital lens can potentially provide for a more rigorous risk assessment process.

In this type of scenario it can be difficult to determine whether a risk assessment or obtaining audit evidence procedure is being performed (or the tipping point at which it moves from one to the other). For example, some technologies can be used to look at the flow of data (such as process mining) within a system and potentially across an entire dataset and financial period. While this could help identify gaps in the flow of data (and highlight whether certain online processes or controls have or have not been performed, or certain transactions put through an alternative part of the system), it could also give rise to a question about whether the residual data population (i.e. the population that successfully went through all the controls, processes and the financial system) has the potential to generate some level of audit assurance, whether further audit procedures are necessary, and if so, what those procedures would be. These hybrid types of procedures may become increasingly common as audit firms continue to experiment and expand their auditor toolkit of procedures and it would be a useful area for the IAASB to consider this type of issue as part of the work of Data Analytics Working Group.

4. Do the proposals sufficiently support the appropriate exercise of professional skepticism throughout the risk identification and assessment process? Do you support the proposed change for the auditor to obtain 'sufficient appropriate audit evidence' through the performance of risk assessment

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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?

Yes, on balance we are of the view that the IAASB has adopted an appropriate approach to dealing with professional skepticism. There is always a danger that over-use of the term professional skepticism (for example if it were to appear in each Requirement and throughout the Application and Other Explanatory Materials) would have a negative impact on auditor behaviour (perhaps leading them to become desensitised to the need to maintain professional skepticism).

We are supportive of the IAASB's emphasis on recognising the central role that professional skepticism plays in an audit and specifically including this as a concept within the introductory paragraphs, the importance attached to the thorough and robust understanding of the entity, its environment and applicable financial reporting framework and highlighting the benefits of exercising professional skepticism during the engagement team discussion (A42).

Specifically we support references and examples made in the Application and Other Explanatory Material to the potential for information to be potentially contradictory (A19) which is also reinforced through further consideration by the engagement team (A44). We are particularly supportive of the notion that individuals and engagement teams need to share their understanding of the entity and continue to use their professional skepticism in order to help identify areas where material misstatements are more like to arise (A47).

With respect to the term 'sufficient appropriate audit evidence' regarding the performance of risk assessment procedures, we believe this may be a less effective change for encouraging professional skepticism. In fact, when used in relation to risk assessment, we find it to be very confusing. We believe that the term sufficient appropriate audit evidence generally relates to obtaining assurance to support the audit opinion and it implies a level of work that goes beyond what should be expected for risk identification and assessment. We suggest removing the need to obtain sufficient appropriate audit evidence from the paragraphs related to risk identification and assessment.

Specific Questions

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:

   As stated in our overall comments on page 1 above, we have significant concerns regarding the requirement to assess design and implementation of controls relevant to the audit and information system controls relevant to financial reporting in situations where the auditor does not plan to take assurance from testing those controls (i.e. the auditor sets control risk at maximum and plans to perform a fully substantive audit). See page 1 for details of our concerns.

   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?

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We believe that the requirements relating to the auditor's understanding of the following components of the entity's system of internal control have been appropriately enhanced and clarified:

- Control environment
- Entity's risk assessment process
- Entity's process to monitor the system of internal control
- Control activities
- The communication part of the component on the information system and communication.

Regarding control activities, we agree with the requirement in paragraph 38 that limits the auditor's understanding of control activities to just those controls that are relevant to the audit within the control activities component.

However, we have concerns regarding the information system component of internal control, as described in the following paragraphs.

<u>Design and implementation of information system controls relevant to financial reporting</u>

Our understanding of the proposals in ED-315 is that the auditor needs to obtain an understanding of the entity's system of internal control relevant to financial reporting (paragraph 25), and then assess design and implementation of only those controls deemed relevant to the audit (paragraph 26).

However, a number of paragraphs in ED-315 add confusion because they seem to require the auditor to obtain an understanding of the 'information system relevant to financial reporting, including the related business processes' (paragraph 35), as well as to evaluate the design and implementation (D&I) of those 'information system controls relevant to financial reporting' (paragraph 36). Related application paragraph A152, which defines 'information system controls relevant to financial reporting', talks about policies and procedures in the entity's financial reporting processes, but does not clarify that they only include controls relevant to the audit. Paragraph A156 refers to evaluating 'the design of the information system and determine whether it has been implemented' without referring to controls at all, which further adds to the confusion. Finally, paragraph A157 implies that 'information system controls relevant to financial reporting' are different than 'controls over the information system [which] are treated as controls in the control activities component and may be identified as controls relevant to the audit'. Therefore, it is not clear whether paragraph 36 is requiring an assessment of D&I of only controls in the information system that are relevant to the audit, or whether the auditor is required to assess D&I of the related business processes in the information system too. Evaluating the D&I of related business processes goes beyond the general principle in paragraph 26 of only assessing D&I of controls relevant to the audit. We are concerned that the confusion between paragraphs 26 and 36 will cause inconsistent application in practice.

Furthermore, it is not clear if the auditor is required to assess the design and implementation of **<u>all</u>** information system controls relevant to financial reporting, or only those that are also determined to be relevant to the audit (as determined by paragraph 39). We believe it should be the latter.

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We believe that for the information systems component of internal control, auditors should still only assess D&I for controls relevant to the audit that are identified in that component. We believe this needs to be made clearer in paragraphs 36, A152, A154, A156 and A157.

Finally, if the expectations on the work effort required to assess controls are the same in paragraphs 26 and 36, we recommend that the related application guidance paragraphs A153 and A198 use consistent wording. It is very difficult to determine the practical difference when applying these two application guidance paragraphs. Alternatively, one of the application guidance paragraphs could be removed and referenced from both requirement paragraphs.

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 audit of smaller and less complex entities?

Compared to the current standard, the ED is now quite clear that the auditor evaluates design and implementation of controls relevant to the audit (paragraph 26). Such controls relevant to the audit can arise in any of the five components of internal control (i.e. not just control activities).

However, the application guidance in paragraph A166 states that controls relevant to the audit are primarily direct controls in the control activities component because such controls are typically over the entity's information system and address risks of material misstatement at the assertion level. It then continues on to say that there may be direct controls in the other components. Our interpretation of these words in the standard is that while there may be controls relevant to the audit in the other components, most controls relevant to the audit will still be in the control activities component.

The definition of controls relevant to the audit in paragraph 39(a) - (d) is fairly clear, particularly given the explanations provided in the related application guidance paragraphs regarding controls over significant risks and journal entries. However, it is still difficult to understand how far the auditor needs to go to identify other controls relevant to the audit as required by paragraph 39(e) - those that "in the auditor's professional judgment, are appropriate to evaluate their design and determine whether they have been implemented to enable the auditor to:

(i) Identify and assess the risks of material misstatement at the assertion level; or

(ii) Design further audit procedures responsive to assessed risks".

The related application guidance in paragraph A179 is helpful because it provides two specific situations (revised information systems and high (but not significant) risks). But a statement (in paragraph 39 or in the related application guidance) that paragraph 39(e) allows other controls to be identified as relevant to the audit but does not require an active search by the auditor would be helpful.

There didn't seem to be much guidance for smaller non-complex entities in this section on controls relevant to the audit other than in paragraph A167 which states that smaller and less complex entities may not have any controls relevant to the audit other than over journal entries. However the guidance in paragraph A167 is useful.

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In addition, ED-315 highlights that a control that is relevant to the audit may be 'implied through actions and decisions' but may not be formally documented. Guidance on performing and documenting the design and implementation of such controls, as well as the operating effectiveness of such controls, would be useful.

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?

The new requirements in paragraph 40 for the auditor to identify IT applications and other aspects of the IT environment that are relevant to the audit are helpful, particularly since paragraph 40(a) to (d) are fairly clear on what makes these IT elements relevant to the audit.

The application guidance in A181 on a smaller less complex entity's use of commercial software is helpful, although we feel it is quite an extreme example. The key to the conclusion that there are no IT applications relevant to the audit is that the entity maintains hard-copy accounting records, which is quite rare these days. Our fear is that auditors will misinterpret this example and use it to support the decision to not assess relevant general IT controls. If this example in A181 is retained, we think it should be emphasized that it is rare that all of those conditions will be met, and that the key requirement is that the entity maintains hard-copy accounting records.

The guidance in A183 – A188 on determining whether IT applications or the IT environment are relevant to the audit was also very helpful.

The requirement in paragraph 41 to identify risks arising from the use of IT is significantly clearer than in the current standard. This explicit requirement should improve the auditor's identification of IT risks. The examples of IT risks in paragraph A145 are useful and easy to understand.

6. Will the proposed enhanced framework of 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?

We support the separate assessments of inherent and control risk at the assertion level. We believe, subject to our responses to other questions in this comment letter, that the guidance on separate assessments of inherent risk and control risk is appropriate.

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?

We believe that the concept of inherent risk factors should help when assessing inherent risks. While there seems to be overlap between several of the inherent risk factors, if the auditor is not separately assessing whether each inherent risk factor is relevant, but rather considering the inherent risk factors holistically when assessing inherent risk, then the overlap may not pose a problem.

However, we are confused by the terminology in paragraph 48 which uses the term 'take into account':

> "... the auditor shall take into account how, and the degree to which:
>
> (a) identified events and conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, the inherent risk factors..."

It is unclear what 'take into account' means; we think further clarification would be helpful. In our view, 'take into account' means to keep these inherent risk factors in mind when assessing inherent risk. We believe that the work effort associated with 'take into account' is less than that of 'consider'. Specifically, the auditor is not required to separately determine if each inherent risk factor is relevant to each event or condition that may give rise to an inherent risk. We believe this is supported by paragraph A245 which makes it clear that "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".

In addition, while the content in *Appendix 2 – Events and Conditions That May Indicate Susceptibility to Risks of Material Misstatement* is useful, we did not find the structure of the appendix to be particularly helpful to the auditor's thought process. It is currently organized by inherent risk factor, where the example events and conditions provided under each inherent risk factor are those that may be most affected by that inherent risk factor. Although the introductory paragraph in Appendix 2 states that the example events and conditions are also likely to be subject to, or affected by, other inherent risk factors to varying degrees, we think this point could be made clearer by restructuring the appendix. For example, we suggest organising the appendix to list the example events and conditions, and beside each one, suggest which inherent risk factor may have an effect on that situation. This would clearly demonstrate that a particular event or condition may be affected by multiple inherent risk factors.

Regarding the impact of inherent risk factors on the final assessment of the inherent risk level on the spectrum of inherent risk, we believe that it would be helpful to include application guidance on how the auditor would do this. Some auditors may believe that if a particular event or condition is affected by multiple inherent risk factors, then the likelihood of material misstatement would be higher, resulting in a higher inherent risk level on the spectrum of inherent risk. Other auditors may not feel that the existence of multiple inherent risk factors for a particular event or condition would necessarily increase the inherent risk level on the spectrum of inherent risk. Any clarification of the IAASB's intent on this topic would be useful guidance to include.

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?

Yes, we agree that the introduction of the 'spectrum of inherent risk' concept has the potential to achieve greater consistency in the identification of risks of material misstatements, including significant risks.

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In our view, introduction of the spectrum of inherent risk concept may result in improved auditor performance in the identification and assessment of risks of material misstatements, as it could lead to:

- More opportunity for engagement teams to think through the volume, mix and relative positioning of inherent risks and ultimately risks of material misstatement;
- Reinforcement of the notion that not all risks are the same and that there is a gradation of 'riskiness' leading to a range of risks, not all of which are deemed significant, which ultimately may lead to a more considered auditor response (which of itself, has to be in the public interest); and
- More informed discussions about risks and responses during Engagement Team Discussions.

We also support the inclusion of additional guidance for engagement teams in the areas of likelihood and magnitude. Emphasising these concepts is helpful to teams and could lead to a more realistic assessment of inherent risks by auditors and engagement teams (i.e. those risks that are likely to occur and are quantitatively or qualitatively material to the financial statements).

While we support the spectrum concept, there are however a number of matters that may not lead to improved consistency:

- By including the spectrum concept only in the Introductory (paragraph 5) and Application and Other Explanatory Materials (paragraph A222) sections, in our view this raises implicit reticence about the importance attached to this new concept by the IAASB. If the IAASB has sufficient confidence that this new change is likely to help achieve greater consistency, then from a public interest perspective we would have expected it to be included more prominently throughout (i) ISA 315 (Revised) in order to drive auditor behavior and (ii) conforming changes in other ISAs (220, 240) to help reinforce this concept. We believe that the requirements in ISA 315 should permit, but not require, a spectrum of inherent risk.
- Early IAASB board papers regarding development of the spectrum concept pointed to a matrix-style approach, however, the explanatory memorandum for ISA 315 (Revised) implies that inherent risks will be scored 'along' a spectrum – implying a more linear approach. In order to help firms focus on development of their training materials, tool or methodology changes, it might be helpful to provide further clarification to confirm one way or the other the Board's vision of how the spectrum is likely to operate. One way of doing this may be through a series of FAQs or other IFAC staff publications. If the likely outcome is that both models could apply, then providing this clarity would also be helpful to firms and auditors.
- Inevitably, there is a danger that the spectrum concept has the potential to introduce another layer of inconsistency into each audit. There is a risk that different people interpret magnitude and likelihood using different personal benchmarks or biases. Ultimately however, we take the view that it will be for firms to make a determination about how to put the spectrum of risk concept into practice. How firms apply this concept, including provision of ongoing training and monitoring its application, will determine how successful the introduction of this concept is likely to be. While the Explanatory Memorandum indicates that introduction of this concept should have no discernible impact on firms' methodologies (and can be applied using a variety of methodologies), this may be an opportunity for some firms to reconsider their approaches to measuring and documenting the assessment of risks. For all of the above reasons, we believe this

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reinforces the need for the IAASB to provide a lengthy period of time between release of the revised standard and effective date.

d. Do you support the introduction of the new concepts and related definitions of significant classes of transactions, account balances and disclosures, and their relevant assertions? Is there sufficient guidance to explain how they are determined (i.e., an assertion is relevant when there is a reasonable possibility of occurrence of a misstatement that is material with respect to that assertion), and how they assist the auditor in identifying where risks of material misstatement exist?

We are generally supportive of the new concepts of significant classes of transactions, account balances and disclosures, and their relevant assertions. However, we are concerned with the definition of 'relevant assertions' in paragraph 16(h) where it equates 'a reasonable possibility of occurrence of a misstatement' to 'the likelihood of a material misstatement is more than remote'. We believe that these terms have different meanings and are likely to lead to misinterpretation and therefore inconsistency in application. Further, we believe that the public interest would not be harmed by removing the very low threshold of 'more than remote' from the definition of relevant assertions as the public would not normally be concerned with risks that are at the low end of the likelihood scale. If the definition remains unchanged, it could lead to a proliferation of potential risks of material misstatement being identified in an audit engagement, which results in the need for auditors to spend time assessing them. In our view, this is not a productive use of time; auditors should be focused on risks that are higher on the likelihood scale.

Therefore, we recommend that the definition of relevant assertions be modified as follows:

> "Relevant assertions – An assertion is relevant to a class of transactions, account balance or disclosure when the nature or circumstances of that item are such that there is a reasonable possibility of occurrence of a misstatement with respect to that assertion that is material, individually or in combination with other misstatements. ~~There is such possibility when the likelihood of a material misstatement is more than remote.~~ The determination of whether an assertion is a relevant assertion is made before consideration of controls."

In addition, the definition of relevant assertion considers only the likelihood of misstatement, but not the magnitude, which is inconsistent with other concepts in the standard (e.g. significant risk and spectrum of inherent risk). We suggest that the definition of relevant assertions also be revised to take into account the concept of magnitude.

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?

Yes, we welcome the revised definition of significant risks and agree that the previous definition had the potential to result in inconsistent application by auditors. The IAASB's decision to create a definition that is about the actual 'risk' rather than the potential response required by an auditor ('…*special audit consideration*…') is particularly helpful.

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We also support the decision of the IAASB to have auditors separately determine significant risks, and to retain a separate definition of significant risks, rather than simply to apply the spectrum of inherent risk to determine relative significance.

The positioning of significant risk, through the definition, as being at the '*…upper end of the spectrum of inherent risks…*' also makes sense in the context of the spectrum of inherent risk approach that we supported in section 6 (c) of this comment letter.

In developing our response to this comment letter, one area that did cause much discussion within our organisation was the decision to include the phrase *'likelihood of a misstatement OR magnitude of potential misstatement'* in the significant risk definition in paragraph 16(k) of the exposure draft. This definition appears to be inconsistent with the wording in paragraph A10 which implies an 'and' condition rather than 'or' through use of the phrase 'as well as':

> "A10. Significance can be considered in the context of how, and the degree to which, the susceptibility to misstatement is subject to, or affected by, the inherent risk factors, which affect the likelihood that a misstatement will occur, **as well as** the potential magnitude of the misstatement were that misstatement to occur."

We believe that a risk of material misstatement should only be significant when it is both likely and material. Further to this issue:

- While we are grateful to the IAASB for the provision of the examples in A222, we did have concerns that these examples, particularly an inherent risk with low likelihood but high magnitude, had the potential to cause greater confusion for auditors and to potentially send the wrong message. This could result in an unnecessary number of significant risks being identified, leading to an audit response in areas that may not be needed and do little to add to audit quality.
- For a significant risk to be at the 'upper end' of the spectrum of inherent risk, we took the view that on balance there had to be a reasonable level of likelihood present for something to be considered a significant risk. We do understand that there may be rare occasions when the 'or' application is appropriate, but given the level of professional judgment applied to likelihood assessments, we believe that auditors will appropriately deal with those situations. In addition, how firms apply the spectrum of inherent risk concept (whether as a linear, matrix or scoring-based system) is also likely to influence how auditors interpret the importance attached to the use of 'or' in the present definition.

We would support a definition that is more understandable for auditors and that does not introduce an inference that significance is driven by an 'either/or' decision. In order to provide clarity, avoid confusion about the 'or' decision, and provide auditors with the latitude to exercise their professional judgement (based on the facts and circumstances present in a particular audit), our recommendation would be to use a modified definition of significant risks, as follows:

Significant risk – An identified risk of material misstatement:

- For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk ~~due to the degree to which one or a combination of the inherent risk factors affect the likelihood of a misstatement occurring or the magnitude of potential misstatement should that misstatement occur~~; or
- That is to be treated as a significant risk in accordance with the requirements of other ISAs. (Ref: Para. A10).

The suggested definition above would be simpler for teams to apply and would not sway engagement teams to always presuppose that something with minimal likelihood but high magnitude is always a significant risk.

We would ask that the IAASB consider developing further implementation support materials to help describe how they envisage the identification of significant risks working in practice, in the context of a spectrum of inherent risks. Specifically, if the definition of significant risks remains unchanged, then clarification about whether a significant risk can be identified on either of the upper ends of the likelihood and magnitudes axes when a matrix approach is being applied, would be particularly helpful.

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

We support the requirement to assess financial statement level risks. However, more clarity is required in how to perform the assessment of financial statement level risks, especially regarding the effects of these financial statement level risks on the assessment of risks at the assertion level.

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?

On balance we are supportive of the 'stand-back' requirement (outlined in ISA 315 paragraph 52) which has been included by the IAASB to drive an evaluation of the completeness of the significant classes of transactions, account balances and disclosures identified by the auditor. In our view, it is likely to be more efficient and effective for auditors to perform this stand-back at a relatively early stage of the audit; other ISAs require auditors to reconsider the impact of changes in facts and circumstances which may lead to identification of additional significant classes of transactions, account balances and disclosures and potential risks of material misstatements throughout the audit.

It will be for firms to determine within their methodologies the optimal point in time to perform the stand-back requirement - although it may be helpful for auditors if the IAASB were to set out (perhaps via IFAC staff resources/FAQs) examples of typical points in the audit cycle when this type of stand-back may be appropriate (for example, Engagement Team Discussion) and also whether the stand-back is performed once or multiple times (given the 'iterative' emphasis outlined in the Explanatory Memorandum).

We note that the current documentation requirements (paragraph 54) outline the various risk identification and assessment requirements that require documentation but paragraph 52 is not explicitly referred to within this section. We also note that part (b) of paragraph 52 of the stand-back requirement uses the words '*...evaluate whether the auditor's conclusion….remains appropriate.*' This gives rise to a question about whether the auditor is therefore required to document the nature, extent and results of such an evaluation. In order to provide clarity to auditors and regulators, it would be helpful for the IAASB to clarify in paragraph 54 whether the expectation regarding documentation extends to the paragraph 52 requirement or not.

In our view, the modifications which have been made to ISA 330 (paragraph 18) do not go far enough (see our response to Question 10 below). Accordingly, our recommendation would be to retain the ISA 315 stand-back requirement and remove the ISA 330 paragraph 18 requirement.

As we outlined earlier in this section, we believe that the stand-back concept should be performed at a relatively early stage of the audit, in order that auditors can reconsider for material (but not significant) classes of transactions, account balances and disclosures whether there could be one or more additional risks of material misstatement at the assertion level. There are a number of reasons why we favour this earlier (ISA 315) rather than later (ISA 330) fail-safe mechanism to capture missing risks of material misstatement; these include:

- The emphasis of ED-315 is on the iterative nature of risk identification and assessment. To promote this concept, it seems contradictory to introduce yet another requirement in ISA 330 at a specified point in time. As a consequence, we would favour one stand-back requirement rather than two potential fail-safe mechanisms.
- As the IAASB has itself noted in ED-315 (see paragraph 63 of the Explanatory Memorandum), ISA 330 (paragraph 18) is also targeted at the same types of 'material' classes of transactions, account balances and disclosures as ISA 315 (paragraph 52) which would indicate some duplication and potential redundancy.
- There is a danger that by leaving this type of review activity until a later stage of the audit (i.e. the design auditor response phase in ISA 330, paragraph 18), that this important reflect and review task is crowded out by other ongoing activities such that it is not given the attention it deserves and there is a lack of real reconsideration.
- We see the risk identification aspects of ISA 330 (paragraph 18) to be redundant on the basis that auditors already have a requirement to review earlier professional judgements that have been made in light of changes in facts and circumstances (see Requirement 53 of ISA 315 and paragraphs 16 and 17 of ISA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing)* and to consider, revise and re-review the planned work as the audit progresses and further information comes to light.
- As currently drafted, ISA 330's (paragraph 18) requirement does not draw sufficient attention to the '*consideration of the assertion(s) in which a possible misstatement could occur'* as this part is hidden within the newly drafted A42a of ISA 330. As a result, there is a real danger that auditors focus primarily on the 'design' part of ISA 330 (paragraph 18) to the detriment of any consideration of gaps in identified risks of material misstatement highlighted in the application materials. As such, we do not believe this potential secondary fail-safe mechanism is likely to be more effective than paragraph 52 in ED-315.
- Given increasing use of automated tools and techniques by auditors to perform risk identification and assessment procedures – providing greater potential for deeper and more extensive analysis through audit data analytics – this, in our view, also adds more weight to the

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inherent value of the ISA 315 (Revised) ED stand-back requirement when compared to the ISA 330 (paragraph 18) requirement.

- The ED-315 changes, when viewed as a whole, provide a more robust set of risk identification and assessment requirements. In our view, this reduces the need for an additional fail-safe mechanism in ISA 330 (paragraph 18).

While we appreciate the efforts of the IAASB to consider the interaction of paragraph 18 of ISA 330 with the revisions proposed to extant ISA 315, we do not believe the case has been made for the retention of both mechanisms and, for the reasons cited above, we favour proposed ISA 315's stand-back requirement as being the more effective of the two potential requirements.

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 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?
    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?

We are generally supportive of the conforming amendments included in ISA 200 and ISA 540.

With respect to ISA 240, one of the conforming amendments was to link the susceptibility to fraud and fraud risk factors to inherent risk factors (ISA 240, paragraph A25 and Appendix 1). ISA 240 describes fraud as 'events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify fraudulent action'. We recommend the standard draw the auditor's attention to the fact that inherent and control risks may indicate the three elements of the "fraud triangle" necessary for fraud to be perpetrated may be present, with brief application material explaining this concept.

We refer to our responses to questions 8 and 10 relating to the conforming amendments proposed in ISA 330. In addition, we feel that a stronger link should be made in ISA 330.07 (and in related paragraphs A10 and A15) to the control risk assessment in ISA 315. As an example, when control risk is set at maximum, the auditor must obtain more assurance from substantive procedures compared to situations where control risk is less than maximum because the auditor tested the operating effectiveness of controls.

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

No, we do not agree with the revisions to ISA 330 paragraph 18 and the accompanying application guidance. We support the IAASB's decision, outlined in the Explanatory Memorandum, that it was also appropriate for the IAASB to consider the ISA 330 (paragraph 18) requirement alongside the planned changes contained in ED-315. We also agree that there has been inconsistent application about how this particular requirement has been applied in practice. We note that regulators and firms have taken differing views about the extent and likely impact of ISA 330 (paragraph 18) and the volume of 'substantive procedures' work that this has entailed.

While we support the decision to look again at ISA 330, we are nevertheless, underwhelmed by the extent of the planned changes made to this particular paragraph which, in our view, only consists of:

- Minor conforming changes of the actual wording of the requirement (i.e. inclusion of the *'quantitatively and qualitatively material'* concept outlined in ISA 315 ED (Revised)), and
- Extensive but ineffective changes to the application guidance as drafted in ISA 330 paragraphs 42-42A of the conforming changes section of the Explanatory Memorandum.

As noted above, one of the areas that has caused confusion for auditors when applying ISA 330 (paragraph 18) has been the extent of substantive procedures that are required when no potential risks of material misstatement have been identified but the classes of transactions, account balance and disclosures are material. We support the clarification about the 'target' of this particular requirement – as outlined within paragraph 42 of ISA 330 application guidance and the link into ISA 315 (Revised):

> *'…substantive procedures are required to be designed and performed in accordance with paragraph 18…for each class of transactions, account balance or disclosure that is not a significant class of transactions, account balance or disclosure, but that has been identified as quantitatively or qualitatively material in accordance with ISA 315 (Revised).'*

These changes still however raise more questions than they answer about how much work (i.e. the volume of *substantive procedures*) will be sufficient to meet the objectives of this particular requirement, especially given that (i) final analytical review procedures are already performed by auditors, and (ii) these classes of transactions, account balances and disclosures have also been subjected to a more rigorous ED-315 suite of risk assessment procedures.

In our view, the ISA 330 requirement is an unnecessary step which is likely to be less effective given our support for the more robust identification and risk assessment procedures outlined in ED-315 (see our responses to Question 8 above) and the extant requirements contained across a range of ISAs, such as:

- ISA 500 *Audit Evidence* (paragraphs 6 and 11),
- ISA 505 *External Confirmations* (paragraph 16),
- ISA 520 *Analytical* Procedures (paragraphs 6 and 7(b)), and
- ISA 560 *Subsequent Events* (paragraphs throughout)

All of the above ISA requirements, taken together with ED-315 and increasing use of technology procedures to help further drive identification and assessment of risks of material misstatement, would, in our view, contribute to sufficient consideration by auditors of whether there are potential gaps from risk or planned audit work perspectives.

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

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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 may 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 the final ISA. Earlier adoption would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

Translations: We have long supported IFAC efforts to make ISAs and other IFAC pronouncements accessible to users through effective and timely translation. Many of the auditing terms and concepts contained in ED-315 are present in other ISAs or defined in the ED so at this stage, we do not foresee any immediate issues in respect of translation. As we noted earlier, the standard itself is now very lengthy which may limit the ability of some auditors to fully comprehend how the standard is intended to work, the interconnected nature of many of the requirements, and the iterative emphasis that the IAASB is keen to promote.

Effective Date: As we noted earlier in our response, given the volume of changes represented by ED-315 and the consequential and conforming changes affecting other ISAs, this is likely to have a significant impact on many audit firms' methodologies. This could include revising internal guidance and the provision of training materials, combined with a lengthy lead-in time to make modifications to automated tools and techniques. As a result, we support an Effective Date which has a **minimum** of 18 months from the point at which the final ISA is published.

We appreciate the opportunity to comment on the IAASB's ED-315, which has resulted in an extensive and comprehensive set of changes to extant ISA 315. We hope that our comments and suggestions will be helpful to you in your deliberations and finalisation of ISA 315 (Revised).

Please contact me should you wish to discuss any of these comments.

Yours sincerely,

BDO International Limited

Chris Smith

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Appendix – Summary of Suggested Minor Edits to Wording

Paragraph Reference	Description of Issue	Markup of Suggested Wording
3	The definition of control risk in ISA 315.03 (and in ISA 200.13(n)(ii)) should be restructured as it is currently very convoluted and difficult to understand. In addition, the definition should also refer to ED-315 paragraph 50(b) to ensure it is clear that control risk needs to be set at maximum if the auditor does not plan to test operating effectiveness of controls. Possible rewording is provided in the next column. This definition would be easier to find if it was included in the Definitions section of ED-315 rather than in the introductory paragraphs.	"Control risk is ~~described as~~ the risk that a **material** misstatement that could occur in an assertion about a class of transactions, account balance or disclosure ~~and that could be material, either individually or when aggregated with other misstatements,~~ will not be prevented, or detected and corrected, on a timely basis by the entity's controls. **However, where the auditor does not plan to test operating effectiveness of the controls for that assertion, paragraph 50(b) requires control risk to be set at maximum.**"
6	When the auditor does not plan to test the operating effectiveness of controls, paragraph 6 states that "control risk is assessed at maximum". The word 'assess' in this context does not seem consistent with how the word 'assess' is used elsewhere in the ISAs. We suggest replacing 'assess' with 'set' as shown in the next column since we believe that 'set' conveys a more objective decision than 'assess' which implies a more subjective process.	"…If the auditor does not intend to test the operating effectiveness of controls related to certain identified risks of material misstatement, the auditor's assessment of control risk cannot be reduced for the effective operation of controls with respect to the particular assertion (that is, control risk is ~~assessed~~ set at maximum)."
48	This paragraph should explicitly state that the requirement to assess inherent risk only applies to relevant assertions.	For identified risks of material misstatement at the assertion level, the auditor shall assess inherent risk **for relevant assertions** by assessing …"
50	This paragraph should explicitly state that the requirement to assess	For identified risks of material misstatement at the assertion level, the auditor shall assess

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	control risk only applies to relevant assertions.	control risk **for relevant assertions** as follows…”
50(b)	When the auditor does not plan to test the operating effectiveness of controls, paragraph 50(b) states that “the auditor shall assess control risk at the maximum”. The word ‘assess’ in this context does not seem consistent with how the word ‘assess’ is used elsewhere in the ISAs. We suggest replacing ‘assess’ with ‘set’ as shown in the next column.	“For identified risks of material misstatement at the assertion level, the auditor shall assess control risk as follows: (a) … (b) … the auditor shall ~~assess~~ **set** control risk at the maximum.”
A10	If the significant risk definition continues to reference ‘likelihood **or** magnitude’, consider removing the term ‘...*as well as*...’ which implicitly acknowledges an ‘and’ rather than ‘or’ concept. The lengthy and cumbersome sentence structure (including 6 commas) could also be improved by making it clear what is the subject of the 2nd part of the sentence.	“Significance can be considered in the context of how, and the degree to which, the susceptibility to misstatement is subject to, or affected by, the inherent risk factors~~,~~**. Inherent risk factors** ~~which~~ affect the likelihood that a misstatement will occur **or**~~,~~ ~~as well as~~ the potential magnitude of the misstatement, were that misstatement to occur.”
A156	Suggest removing ‘may’, as shown in the next column, as the points listed all contribute to our understanding.	“… the auditor’s understanding of the sources of data, and the IT applications involved in processing that data, ~~may~~ also assist the auditor in understanding the IT environment.”
A245	Consider removing the struck out part of the sentence which is a circular argument and does not add any clarity.	“More detailed documentation may be required where the auditor applies a higher level of professional judgment~~, for example when exercising professional judgment to support the rationale for difficult judgments made~~.”

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