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529 Fifth Avenue, 6th Floor
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NY 10017, USA

submitted electronically through the IAASB website

Re.: Exposure Draft: Proposed International Standard on Auditing 315 (Revised)

Identifying and Assessing the Risks of Material Misstatement and Proposed Consequential and Conforming Amendments to Other ISAs

Dear Dan,

We would like to thank you for the opportunity to provide the IAASB with our comments on the 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", hereinafter referred to as "the draft".

We have provided some overarching comments on the draft in this letter. Our comments responding to questions posed in the Explanatory Memorandum are included in Appendices A (Overall Questions), B (Specific Questions), C (Question on the Conforming and Consequential Amendments), and D (Request for General comments).

We have become increasingly concerned about some developments in the standard setting process at the IAASB and our responses to the questions posed in the Explanatory Memorandum reflect those concerns. We recall that the original audit risk project (which started as a project among major standard setters) commenced in the mid-1990s and was completed around 2004; further refinement took place through the Clarity Project by the end of 2008. This represents a time period of about nine years followed by another four years. The fact-finding for the current project effectively commenced in March 2016, but the project itself commenced its work shortly after September 2016 and has already

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issued an exposure draft with fundamental changes in mid-2018. We recognize that the world is becoming faster-paced, but we also believe that the prime indicator of robust standards is their ability to stand the test of time despite the faster pace of disruptive change. To draft such robust standards, more time, rather than haste, is needed.

We agree that a revision of ISA 315 is needed to address the issues arising from implementation monitoring and inspections and that this project be undertaken. However, our analysis of the draft indicates to us that not enough time has been spent on fundamental issues resulting from the interplay between the definitions and the requirements, and that these will lead to a considerable increase in work effort on audits and a more bureaucratic approach to audits; we are convinced that the increase in work effort will not be worth the increase in assurance obtained. These changes will also be detrimental to the scalability of audits – particularly for audits of smaller and less complex entities. The fact that a few particular national audit regulators (regardless of whether or not they use the ISAs) that have less interest in the broad application of the standards to all kinds of audits worldwide desire certain matters in standards in a short period of time is – from our point view – not a reason for an international auditing standard setter to allow itself to be put under time or technical pressure.

The draft includes many useful improvements to risk assessment, including to the understanding of the entity and its environment, the introduction of the inherent risk factors, the clarification of the meaning of a significant risk and how it is determined, the auditor's consideration of the components of internal control, and the consideration of IT in risk assessment. It is unfortunate that these significant improvements are, from our point view, overshadowed by some of the fundamental changes that we regard to be disproportionate.

We are also concerned that the draft is not understandable: we are convinced that due to the subtlety of the terminology used and process described, outside a small group of experts in standard setting or large network methodologies, few practicing auditors – especially not those SMPs that audit financial statements of small and less complex entities – will be able to understand and apply the standard as drafted. We also believe that the length of the draft will be a barrier to acceptability: much of the application material appears to read like a textbook or audit manual on risk assessment, rather than pithy, well-directed guidance needed to understand the requirements.

Overall, we hope that the IAASB will take our comments in the spirit in which they are being given, which is to help the IAASB to continue to issue auditing standards of global application for all kinds and sizes of audits by addressing those matters of concern in relation to this draft.

We would be pleased to provide you with further information if you have any additional questions about our response and would be pleased to be able to discuss our views with you.

Yours truly,

Klaus-Peter Feld	Wolfgang P. Böhm
Executive Director	Director, Assurance Standards, International Affairs

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Appendix A: Comments on Overall Questions

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)?

As our response to question 6 indicates, we believe that the description of the risk identification and assessment process has become more difficult to understand – partly through the design of the definitions and the use of terminology. While the flow charts are helpful, the fact that three complicated flow charts are needed to describe the process demonstrates that the process – or at least its description through the subtleties of the terminology used – has become too complicated. We are convinced that outside a small group of experts in standard setting and large network methodologies, few practicing auditors – especially not those SMPs that audit financial statements of small and less complex entities – will be able to understand and apply the standard as drafted.

The fact that the description of the process seeks to depict how requirements interact and are iterative in nature appears to be a part of the problem. It would be better to describe a non-interactive and non-iterative process in the requirements for the main process, describe the required iterations at one point in the requirements, and describe the interactions in the application material, rather than to seek to depict the interactivity and require the iterations within the requirements for the main process itself. Furthermore, the fact that no less than 247 application material paragraphs (not to mention the appendices) are required to help auditors understand the process is a clear indication that the process or its description thereof, or both, have been overengineered – particularly for audits of financial statements of small and less complex entities.

(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?

We believe that the question posed as to a more robust process falls short of what needs to be asked. The question that needs to be asked is whether the revisions will lead to an increase in work effort that is worth the increase in the depth of risk assessment and hence increase in assurance obtained. As we note in our responses to questions 5, 6 and 9 (b), we have concluded that the interplay between the definitions and requirements will lead to a work effort that would not be worth the increased assurance obtained: consequently, we are not convinced that the public interest would be served in relation to these matters – particularly for the audits of financial statements of small and less complex entities. In particular, we believe that the scalability as a public interest issue has not been adequately considered.

We do wish to acknowledge that the draft has provided many useful revisions, such as the introduction of the inherent risk factors, the clarification of the meaning of a significant risk and how it is determined, the auditor's consideration of the components of internal control, and the consideration of IT in risk assessment, that represent improvements and that will assist auditors in undertaking more consistent and more robust audits. It is unfortunate that these improvements are overshadowed by the other weaknesses in the draft that we address in our comments.

(c) Are the new introductory paragraphs helpful?

Yes, the new introductory paragraphs are helpful, just as the flowcharts are. However, the fact that such an "overview" of the process is necessary at the beginning of the draft is an indication that the requirements as written do not lead to a description of the process that is sufficiently understandable. In addition, a correct overview of a process that we believe is flawed does not alleviate the flaws that we believe we have identified.

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 sized, complexities and circumstances?

As noted above and in our responses to questions 5, 6 and 9 (b), we have concluded that the interplay between the definitions and requirements will lead to a risk assessment process whose increase in work effort will not be worth the increased assurance obtained for all audits, and that this will have a detrimental impact upon the scalability of the standard for audits of financial statements of smaller and less complex entities. Our responses in the questions noted point to those areas where we believe a lack of scalability will ensue.

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?**

   We agree with the approach taken in the draft in relation to automated tools and techniques, including data analytics, through the use of examples to illustrate how these are used in an audit. There are, however, many issues that remain unresolved with respect to automated tools and techniques as identified in responses to the IAASB consultation paper on data analytics, but we recognize that the project to revise ISA 315 may not be able to resolve these. For these reasons, we very much welcomed the initiative by the IAASB in its previous consultation on the issue and urge the IAASB to address these issues as part of its contemplated new project on audit evidence in the near future.

4. **Do the proposals sufficiently support the appropriate exercise of professional skepticism throughout the risk identification and assessment process? Do you support the proposed change for the auditor to obtain 'sufficient appropriate audit evidence' through the performance of risk assessment procedures to provide the basis for the identification and assessment of the risks of material misstatement, and do you believe this clarification will further encourage professional skepticism?**

   In our view, since professional skepticism is an attitude that resides within individual auditors, we believe that the character, education and training of auditors is more important than auditing standards for the appropriate exercise of professional skepticism. However, although standards can facilitate the appropriate exercise of professional skepticism, we are not convinced that adding more requirements and application material necessarily improves professional skepticism. While no particular requirement or guidance that we have seen in the draft would not facilitate professional skepticism, the fact that the standard is so difficult to understand for practitioners may actually impair the exercise of professional skepticism.

We do not support the change for the auditor to obtain sufficient appropriate audit evidence through the performance of risk assessment procedures to provide the basis for the identification and assessment of the risks of material misstatement, because the term sufficient appropriate evidence as currently used in the ISAs and all other IAASB assurance standard is associated with the evidence that the auditor obtains to reduce audit risk to an acceptably low (reasonable assurance engagements) or acceptable (limited assurance engagements) level – not to perform a risk assessment, which results in an assessment of the level of the risk of material misstatement. It would have sufficed to have the auditor "obtain an *appropriate basis* through the performance of risk assessment procedures for the identification and assessment of the risks of material misstatement", since the word "appropriate" in the English language would cover both kind and amount (unless paired with "sufficient" as in the phrase "sufficient appropriate audit evidence" as used in the ISAs). We are not convinced that the terminology used in this requirement will have any impact on the exercise of professional skepticism.

Appendix B: 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 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?

Our consideration of paragraphs 25 to 44 and the related application material indicates that the requirements related to the auditor’s understanding of each component of the entity’s system of internal control has been largely clarified. However, whether these have been appropriately enhanced is another issue. We agree with many of the changes and additions. However, we strongly disagree with the change relating to obtaining an understanding of the information system and communication.

Due to the definition of “significant classes of transactions, account balances and disclosures” in paragraph 16 (j), which means these are significant if there is at least one relevant assertion, and the definition of “relevant assertion”, which essentially defines a relevant assertion as one in which the likelihood of material misstatement is *more than remote* (a very low threshold), the draft <u>dramatically broadens the scope</u> of those classes of transactions that are significant for purposes of paragraph 35 (a), compared to the classes of transactions that (together with the definition of “significance” in the IAASB Glossary) would have been construed as significant for the purposes of paragraph 18 (a) in extant ISA 315. This dramatic broadening will lead to almost no classes of transactions, account balances and disclosures being regarded as not significant for the purposes of paragraph 35 (a) in the draft. This broadening also implies a very large increase in work effort for obtaining an understanding of the information system. Furthermore, such broadening would also involve a significant increase in work effort for the evaluation of the design of the information system controls relevant to financial reporting as required by paragraph 36 of the draft.

It is clear to us that obtaining an understanding of the information system can be an important source of information to enable the identification of both risks of material misstatement at the financial statement level and inherent risks (which are defined as being at the assertion level). We also recognize that such an understanding also provides information to enable the assessment of those risks and the assessment of control risks (also defined at the assertion level). To this effect, we disagree with the statement in the question that such understanding "informs" the "risk identification and assessment *process*": it provides information that is used to help identify and assess the noted risks. However, from a public interest perspective, we are not convinced that lowering the threshold of significance in this way with the concomitant large increase in work effort will lead to an increase in assurance that is worth the resulting increase in work effort. We refer to our proposal in our response to (d) below, in which we suggest a more reasonable threshold for a relevant assertion that would also make the standard more scalable for audits of financial statements of smaller and less complex entities.

(b) Have the requirements related to the auditor's identification of controls relevant to the audit been appropriately enhanced and clarified? Is it clear how controls relevant to the audit are identified, particularly for audits of smaller and less complex entities?

Based on our consideration of paragraph 39 of the draft, we believe that the requirements related to the identification of controls relevant to the audit have been largely clarified. We agree with many of the enhancements made, but strongly disagree with the requirement in paragraph 39 (b).

We recognize that paragraph 39 (b) reflects an existing requirement in extant ISA 315. However, this requirement has caused considerable controversy among auditors of financial statements of smaller and less complex entities, who believe they are being asked to test the design of controls when this is not necessary. As noted above, we acknowledge that testing the design of controls can be an important source of information to enable the identification of both risks of material misstatement at the financial statement level and inherent risks (which are defined as being at the assertion level), and to enable the assessment of those risks and of control risks (also defined at the assertion level). However, there are many circumstances – particularly in smaller and less complex entities – in which, based on previous experience with the entity, the auditor knows in advance that particular inherent risks (which are defined at the assertion level) will be close to the upper end of the spectrum of inherent risk and are therefore significant risks as defined. Furthermore, based on previous experience with the entity, the auditor will also know in advance that he or she will not be relying on the operating effectiveness of controls in relation to those inherent risks and that the auditor expects to obtain sufficient appropriate audit evidence in relation to those risks through substantive procedures alone. The auditor may also expect to be able to design appropriate substantive procedures to address those inherent risks because the risks did not arise due to the inherent risk factor "complexity". Essentially, this means that the auditor expects the financial statements to be materially misstated in relation to the noted inherent risk and that the auditor expects to need to communicate the material misstatement determined by the auditor to management and to request management to correct that misstatement pursuant to ISA 450.8.

In these circumstances, testing the design of controls related to those significant risks when those risks are not complex would not lead to more information for the identification or assessment of inherent or control risks, nor be helpful in the design of substantive audit procedures to address the inherent risks. Hence, performing tests of design of controls are superfluous because there is no added benefit to performing them. Consequently, we believe that paragraph 39 (b) should only require controls to be considered relevant when inherent risks are considered significant due to their being treated as a significant risk in accordance with the requirements of other ISAs or due to the "complexity" inherent risk factor.

(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 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?

We support the introduction of the definitions of general information technology controls and IT environment (however, in the definition of IT infrastructure therein, "is comprised of" needs to be corrected to "is composed of" or "comprises", and the second sentence of the definition of application controls needs to be moved to the application material). We also agree that the auditor shall obtain an understanding of the IT environment relevant to the information system as required by paragraph 35 (d), even though, as noted in our response to (a) above, we disagree with the scope of that understanding as required in paragraph 35 (a) that results from the definition of *significant* classes of transactions, account balances and disclosures. One matter requiring further clarification throughout the standard (both requirements and application material) is the use of the term "risks arising from the use of IT": risks of what? Risks of material misstatement at the financial statement level? Inherent risks? Control risks? All of these? We presume that since the IT environment, general IT controls and IT applications are dealt with in the draft in the sections on internal control and therefore represent a part of the internal control system, these relate either to risks of material misstatement at the financial statement level (e.g., control environment) or control risks. If not, then further clarification is needed (our response to main question 6 indicates why, in our view, simply using "risks of material misstatement" to remedy this will not suffice).

We also support the introduction of concepts relating to data warehouses, report-writers, and networks in paragraphs A7 and A8 of the draft. However, they are currently written like definitions. Either these need to be moved to the definitions section, or the wording needs to be changed in the application material to assert that this is how these terms may be commonly understood.

While we support the requirements in paragraphs 40 and 41 addressing such matters as automated controls, [controls over] the integrity of information, [controls over] system-generated reports, and general controls, we do not believe that these requirements have been appropriately integrated into the concept of relevant controls so that it is clear when these controls over IT are relevant ("take into account… address or include" as used in paragraph 40 is rather vague), nor has the issue of controls over IT been appropriately structured so that auditors have clear conditions when the controls over IT are relevant.

We also note that paragraph 41 (a) deals with the identification of "risks arising from IT". We presume this risk identification relates primarily to control risk (see above). If so, this matter ought to be dealt with in the section that deals with the *assessment* of control risk around paragraph 50 of the draft.

6. Will the proposed enhanced framework for the identification and assessment of the risks of material misstatement result in a more robust risk assessment?

Since our greatest concerns with the draft relate to some fundamental issues addressed in this question, we will address the main fundamental issue first before addressing the impact on each of the sub-questions in (a) to (e).

We would like to point out that the current ISAs contain a number of definitions related to "misstatement" and "risks of misstatement" that are not being changed by the draft. <u>This means that these existing definitions continue to apply.</u> In particular, we note the following:

- Both ISA 200.13 (i) and ISA 450.4 (a) essentially define a misstatement as the difference between what the financial statements actually depict and what they ought to depict. This means that, unless there is a visible impact on what is depicted in the financial statements, there is no misstatement. It follows that a material misstatement only exists when the difference between what is actually depicted in the financial statements and what ought to be depicted is material.
- ISA 200.13 (n) defines the risk of a material misstatement as the risk that the financial statements are materially misstated prior to audit. This means that the term "risk of a material misstatement" relates to the risk that the difference between what is actually depicted in the financial statements and what ought to be depicted is material. Hence, if for the sake of argument, one disregards the following definitions of inherent and control risk in ISA 200.3 (n) and the description of "risks of material misstatement at the financial statement level" in ISA 315.A122, under the current ISAs there is no such thing as a risk of material misstatement for something other than what is depicted in the financial statements.[1]

[1] There is one exception to this conclusion: the definition of "tolerable misstatement" in ISA 530.5 (i) also refers to "misstatement", but the definition is limited to audit sampling.

- The word “risk” is not defined in the current ISAs, but ISA 315.26 (d) clarifies that it involves the “likelihood” of misstatement – i.e., its probability. By definition, the likelihood or “risk” of misstatement therefore ranges from 0% to 100%. This also implies that there is “no risk” of misstatement only when such risk is 0 %. Due to the pervasiveness of the completeness issue, it is difficult to envisage circumstances in which it is absolutely certain that risks of misstatement, and hence risks of material misstatement, are zero.
- ISA 200.13 (n) does define inherent and control risks, but in doing so addresses the sources of risks of material misstatement (i.e., the two factors – inherence and the effect of controls – that affect the probability of misstatement). In addition, inherent and control risk are defined at assertion level, and thereby the definition moves beyond what is depicted in the financial statements to what management implicitly or explicitly asserts when depicting matters in the financial statements (see ISA 315.A127) in terms of recognition, measurement and presentation of classes of transactions and events, account balances and disclosures. ISA 315.A128-.A130 explain how assertions are used as a tool by auditors to consider potential misstatements and provides some useful categories of assertions that need to be covered but that can be expressed differently by auditors.
- ISA 315.A122 describes the “risk of material misstatement at the financial statement level” as those risks that relate pervasively to the financial statements as a whole and potentially affect many assertions – that is, circumstances that may increase the risks of material misstatement at assertion level. In this case, the ISAs are also dealing with causes of risks of misstatement at the assertion level, but in particular those that affect multiple assertions.

In conclusion the ISAs currently only require consideration of risks of material misstatement in terms of the impact on what is depicted in the financial statements, and at assertion level. ***There is no requirement for a “drill-down” below assertion level (that is, the determination of risks of material misstatement or inherent or control risks such that there is more than one such risk for each assertion).*** Consequently, although of course the ISAs do not forbid such a drill-down, and some firm methodologies and other guidance do use or address a drill-down to assist auditors, the fact that such a drill-down is not a requirement means that when the term “risks of material misstatement” is used in the current ISAs, it refers to inherent and control risks (which are at assertion level), and in some cases the risks of material misstatement at financial statement level, *collectively* – not to one or more risks within an assertion. The use of the term "identify and assess risks of material misstatement" to refer to these risks collectively in many of the requirements in extant ISA 315 works well because the current ISAs accept a combined identification and assessment of the inherent and control risks.

The draft of ISA 315 proposes that inherent risks and control risks each be assessed separately, with which we agree for the reasons noted in our response to (a) below. However, the current draft continues to use the term "risks of material misstatement" and "susceptibility to misstatement" (which means the same thing) in relation to identification and assessment of risks throughout the requirements and guidance, even though a separate assessment of inherent and control risk is required. It begs the question as to why the term "inherent risk" is not used when seeking to address the susceptibility of an assertion to misstatement without consideration of control or when addressing the risks of material misstatement that controls address. Furthermore, we note that paragraph A9 in the application material to the definition of "relevant assertion" states

> "There will be one or more risks of material misstatement that relate to a relevant assertion" [underlining added]

The second bullet of paragraph 48 in the explanatory memorandum explains the same point. **On the basis of this analysis, we can only come to the conclusion that the draft intends to require a drill-down below assertion level and that the term "risk of material misstatement" is being used to describe the possibility of multiple risks of material misstatement for each relevant assertion.** The use of terminology in this way is also confusing to practitioners because it is unclear when in fact the term is used to describe inherent and control risks (and the risks of material misstatement at financial statement level) collectively, rather than for the drill down as described in paragraph A9. Furthermore, the use of "risk of material misstatement" to refer to the drilled-down risks violates the definitions in the ISAs that continue to be applicable to the draft.

We recognize that no separate "identification" of control risks can take place, because once an inherent risk has been identified, a concomitant control risk automatically exists (albeit without any consideration of whether it is below maximum or not). However, we believe that rather than using "risk of material misstatement" with the thought of covering this fact throughout the standard, it would be much clearer to speak of inherent risks and that application material to paragraph 50 explains that the control risks need not be separately identified for the reasons noted.

We do not believe that the impact of the change to effectively requiring such a drill-down has been appropriately exposed because we have become aware that most readers of the draft around the world did not recognize the impact of paragraph A9 or why "risks of material misstatement" was used when "inherent risk" would have otherwise sufficed. In addition, we do not believe that the benefits of such a drill-down are worth the benefits in all cases – particularly for audits of financial statements of smaller and less complex entities – and would undermine the scalability of audits in that sector. For these reasons, we believe that paragraph A9 needs to be deleted, or at least changed so that it clarifies that firm methodologies and other guidance may address risks of material misstatement at below assertion level, but that this is not required. Furthermore, the use of terminology needs to be simplified throughout the draft so that when addressing any risks of material misstatement at assertion level before consideration of controls, the term "inherent risk" (which is defined at assertion level) is used. Such simplification would go a long way to improving the understandability of the draft.

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 note that extant ISA 315.2 requires auditors to identify significant risks by excluding the effects of controls related to that risk. Given our response to the main question 6 above that extant ISA 315 only requires the identification and assessment of inherent and control risks, both of which are at assertion level, and not any drill-down below assertion level, extant ISA 315.27 has therefore always required a separate assessment of inherent risk for the purposes of identifying significant risks. For these reasons, we do not believe that the introduction of separate assessments of inherent and control risk would involve a significantly greater burden, if at all. Furthermore, we believe that separate consideration of inherent risk helps auditors consider the impact of controls in a systematic manner. For these reasons, we support the separate assessment of inherent and control risks.

However, as noted in our response to the main question 6 above, we believe that the terminology used needs to be clear by referring to the identification, and assessment, of inherent risk, and the assessment of control risk separately, rather than referring to the "identification" or "assessment" of the "risks of material misstatement". This would also result in a rationalization and simplification of the requirements in paragraphs 45 to 50 of the draft.

(b) Do you support the introduction of the concepts and definitions of 'inherent risk factors' to help identify risks of material misstatements and assess inherent risk? Is there sufficient guidance to explain how these risks factors are used in the auditor's risk assessment process?

We support the introduction of the concept and definition of "inherent risk factors" to help identify <u>inherent risk</u> (see our comments above to the main question 6 above; as well note that these are "inherent risk factors", not "material misstatement risk factors") and assess inherent risk because these provide a useful basis for such identification and assessment. However, we are not convinced that "subjectivity" and "uncertainty" are actually different concepts (the need for subjectivity only arises when there is "uncertainty") and that these therefore ought to be merged. Furthermore, in the second sentence of the definition of inherent risk factors, the words "may be" need to be changed to "are" because the statement that such factors are qualitative or quantitative is a statement of fact (they can be one or the other or both, but not anything else). Otherwise, due to the use of the word "may", that sentence would need to be moved to the application material. Our comments above about the use of terminology (risks of material misstatement vs. inherent risk) apply to both the definition and the application material thereto. As a further observation, we would like to suggest that in paragraph A5 in the description of "uncertainty", the terms "best available", "comprehensive" and "to the extent available" be removed from the description of "uncertainty" or be changed, as superlatives ought to be avoided unless needed and the other words are too open-ended.

We also note that paragraph A6 is written like a definition, rather than application material, which leads to lack of clarity as to whether auditors are required to consider these factors too. Either the word "may" needs to be inserted prior to "include" or the content of A6 needs to be moved to the definition.

(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?

We believe that the introduction of the concept of a spectrum of inherent risk will assist auditors in assessing inherent risks (rather than risks of material misstatement: note that in the term "spectrum of inherent risk", the spectrum relates to inherent risk – not risk of material misstatement), but will have no impact on their identification (see our response to (d) for why this is the case). Furthermore, such introduction will also assist auditors in determining when inherent risks (rather than risks of material misstatement) are significant risks. We also agree that to do this, auditors need to assess the likelihood and magnitude of potential misstatement. We surmise that the guidance will assist auditors in being more consistent in such risk assessments as well.

However, in addition to the use of terminology as noted in our response to the main question 6 above, we disagree with some of the concepts and wording in the requirements.

First, paragraph 48 refers to "assessing the likelihood and magnitude of *material* misstatement." This is logically incorrect: one can assess the likelihood and magnitude of misstatement, or the likelihood of material misstatement, but not the likelihood and magnitude of material misstatement, because the threshold for needing to act as an auditor is when the magnitude is material. The only consideration of magnitude beyond materiality occurs when auditors consider whether misstatements are material and pervasive under ISA 705 (and perhaps when considering going concern issues) – but not as part of the assessment of inherent risk. Hence, the word "material" needs to be deleted. The same applies to the wording in application material in paragraph A221 und A222.

Second, paragraph 48 (a) requires the auditor to take into account the degree to which identified events and conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, inherent risk factors. In our view, since inherent risk is defined at assertion level, the consideration of inherent risk factors needs to be done by relevant assertion – not by significant classes of transactions, account balances and disclosures: the wording therefore needs to be changed accordingly.

We also note that, based on our comments on main question 6 above, 48 (b) could be rationalized to read "… affect the assessment of inherent risks", for as noted, inherent risks are at assertion level. The same applies to paragraph 49, which should be rationalized to read "…assessment of inherent risks, any of these assessed risks are significant risks". Likewise, paragraph 50 should be changed to read "For identified inherent risks…", and 50 (a), (b) and 51 should be changed to read "… to respond to an inherent risk" not only for the reasons already noted, but also because controls respond to inherent risks, not "risks of material misstatement". The same applies to the related application material.

(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?

Although we support the idea of introducing definitions for "significant classes of transactions, account balances and disclosures," and for "assertion," and "relevant assertion," we do not agree with the content of those definitions. We have already addressed in our response to question 5 (a) our main issue with the definition of "significant classes of transactions, account balances and disclosures" resulting from this definition's use of the defined term "relevant assertion".

We also believe it may be helpful to define what "classes of transactions" and "account balances" and "disclosures" mean.

Definition of Assertion

We believe that the definition of "assertion" and its related application material confuses a number of different meanings of that term. There are three potential uses to the term "assertion" in the context of ISA 315:

- Using the Assurance Framework and ISAE 3000 as a basis for understanding, to refer to the individual explicit and implicit representations that *would be* contained in the subject matter information (the financial statements) if the criteria (the requirements in the applicable financial reporting framework regarding recognition, measurement, presentation and disclosure) are *appropriately* applied to the underlying subject matter (the transactions, events and conditions and other circumstances of the entity). This concept can be called the "*required assertions*".

- To refer to the individual explicit and implicit representations as noted above *actually contained* in the financial statements as prepared by management. This concept can be called the "*actual assertions*".
- To refer to the tools used by auditors to identify inherent risks and assess inherent and control risks. These tools are based on the "*required assertions*" as noted above but are generally summarized into categories that are not as granular as the individual requirements of the financial reporting frameworks that would be reflected in the *required assertions* as defined above. This concept of "tools the auditor uses" can be called the "*auditor assertion categories*".

At a theoretical level, an audit involves the auditor comparing the *actual assertions* to the *required assertions* by applying the *auditor assertion categories* to determine whether there are material differences between the actual and required assertions.

The first sentence of the definition of assertions in the draft refers to the actual assertions. The second sentence of the definition of assertions in the draft refers to the auditor assertion categories. The application material to the definition of assertions in paragraph A1 of the draft refers to the actual assertions. Consequently, the use of the defined term "assertions" in the draft is extremely confusing because readers of the draft would not know which of these three concepts is meant when the term "assertions" is used in the work effort requirements and guidance of the draft. This is important because the definition determines the required granularity of the assertions and what "assertion level" means in practice. The definition of assertions as written now would require a drill-down to the individual requirements of the financial reporting framework rather than permitting the use of categories as described in paragraph A204 of the draft: application material such as in paragraph A204 cannot contradict a requirement or definition.

We surmise that when the term “assertions” is used in the work effort requirements and guidance in the draft, the “auditor assertion categories” as described in paragraphs A203 and A204 of the draft are being referred to. For these reasons, and to rationalize the definition of assertion based on our responses to the previous questions, we suggest that the following definition be used for assertions:

> “Summary categories of explicit and implicit representations that would be contained in the financial statements if the financial statements are appropriately prepared in accordance with the financial reporting framework. These summary categories are required to be used by auditors to consider different types of potential misstatement.”

The important features of this definition are: 1. Assertions as defined are required to be used by auditors to consider potential misstatements (i.e., this is an auditor tool that ISA 315 requires to be used), 2. The assertions represent *summary categories* of the explicit or implicit representations in the financial statements that result when applying the financial reporting framework – not the granular representations that result when applying detailed requirements of the financial reporting framework, and 3. The summary categories relate to what would be contained in the financial statements if the financial reporting framework is appropriately applied – not to the actual assertions in the financial statements as prepared by management. The reference to recognition, measurement, presentation and disclosure need not be included in the definition, but can be included in the application material to the definition, as is currently the case in extant ISA 315.A127.

It would also be important that the application material in paragraph A5 clearly distinguishes that this description of assertions relates to the actual assertions in the financial statements as prepared by management, rather than the assertions as we propose be defined above.

Definition of Relevant Assertion

As noted above in our response to the main question 6, we also disagree with the use of the definition of “relevant assertion” because of its connection to a class of transactions, account balance or disclosure, and we also disagree with the use of “material misstatement” when “inherent risk” would be more appropriate. However, more importantly, we strongly disagree with the use of the threshold “reasonable possibility” in connection with “more than remote likelihood”. We believe that a “more than remote likelihood” is far too low a threshold because it would cause an excessive number of assertions to be regarded as relevant and thereby result in auditors identifying and assessing inherent risks that are exceedingly unlikely to be the cause of material misstatements. This is a particular issue for audits of financial statements of smaller and less complex entities: the low threshold would have a very detrimental effect on the scalability of the standard and lead to an excessively bureaucratic approach to risk assessment.

We recognize that the term “reasonable possibility” is used in PCAOB Auditing Standards and that through reference it means “a more than remote likelihood”. Deleting the reference to “remote likelihood of risk” in relation to the threshold “a reasonable possibility” in the draft would not represent a reasonable solution because readers of the draft would still assume that a “reasonable possibility” means the same as that use of the term in PCAOB Auditing Standards.

For these reasons, we have come to the conclusion that a different threshold needs to be applied that uses a term other than “reasonable possibility”.

We recognize that the threshold for identifying inherent risks prior to their assessment (i.e., the “educated guess” as noted in the Explanatory Memorandum) needs be lower than an acceptably low level of risk as used in ISA 200 so that auditors can assess those risks that are just below this latter threshold to determine whether they are in fact acceptably low or not. For these reasons, in line with ISA 200 we believe that the appropriate threshold relates to the consideration of whether it is unlikely that inherent risk is acceptably low. Based on all of these considerations we believe that the definition of a relevant assertion should read as follows:

> “An assertion is relevant when the auditor believes that its inherent risk is unlikely to be acceptably low.”

The reference to “its inherent risk” automatically brings in all of the definition of inherent risk (see ISA 200.13 (n) – i.e., see what happens when you substitute “its inherent risk” with the definition of inherent risk), which makes the definition shorter and clearer without losing anything important, and includes the “auditor’s belief”, which involves the character of an educated guess.

A further reduction in complexity of the draft through a rationalization of the requirements resulting from the use this definition can also be achieved by merging the identification and assessment of inherent risks and hence the identification of relevant assertions: such identification and assessment need not be separate steps and in practice often occur concurrently.

Use of Risk Thresholds

The end of sub-question (d) above refers to "identifying where risks of material misstatement exist". The meaning of this term in existing ISAs was always unclear to readers, so we welcome the attempt to provide some clarification in paragraph A211. However, there are a number of issues with this attempt at clarification. First, not only is this extremely important matter far back in the application material, it is also in the middle of a paragraph of a number of sentences, which means many readers will not become aware of this clarification.

Second and more importantly, the sentence contains an inherent contradiction: the sentence essentially states that when there is a remote possibility of a material misstatement, there is no identified risk of a material misstatement, which is an inherent contradiction because one had identified a risk of material misstatement with a remote likelihood of occurrence. As noted in the third bullet point of our response to the main question 6 above, no risk implies zero risk, which is not the case when there is a remote possibility of a material misstatement. This inherent contraction is exemplified in paragraph 45 which states that the auditor should "identify risks of material misstatement <u>and</u> determine whether they exist": we note that under A211, if they have been identified, they must exist.

Third, *seeking to distinguish an "identified risk of material misstatement" (which is then equivalent to the "existence of a material misstatement") from "a risk of material misstatement" that was identified as part of the identification of relevant assertions is just too subtle for most readers to understand.* Fourth, as noted in our response above, we do not believe that "remote likelihood of risk" is the appropriate threshold to use. Fifth, this threshold does not articulate with the threshold "acceptably low level of risk" used in ISA 200 and elsewhere, which represents the converse of reasonable assurance, and therefore the use of risk thresholds throughout the ISAs is internally inconsistent.

We recognize that this weakness about the meaning of “risks of material misstatement exist” or “no risks of material misstatement exist” is in the extant ISAs, but we believe that the IAASB should take this opportunity to ensure that the ISAs use an internally consistent approach to rationalize the risk thresholds used (e.g., acceptably low level of risk, existence of risk, no risk, assessed risk, remote likelihood of risk, potential risk, possible risk): a limited number of minor conforming amendments in the other ISAs could resolve the issue. Throughout the drafts, we also note instances in which the term “risk” or “risks” are used in which it is not clear what the risk or risks relate to: i.e., risk of what? In some cases, if a risk or risks are clearly identified in the beginning of a paragraph, the solution may be to simply use “this risk” or “these risks”, but in other cases it is completely unclear which risks are meant. In these cases, we suggest that clarification be provided.

We would like to point out that other professions, whether scientists, engineers, actuaries, or statisticians, have a clear conception of what a risk means: in the long run, the IAASB’s standards cannot afford to use “code” that is at variance with how risk is generally understood worldwide and that only those who are aware of A211 will understand. It also leaves the impression to those outside of the auditing profession that the auditing profession and the IAASB do not understand the meaning of risk.

Rather than seeking to replace “risks of material misstatement exist” and the like throughout the ISAs with phrases like “risks of material misstatement are not acceptably low”, it may be simpler to replace the noted phrase in the other affected ISAs regarding responses to risk along the lines of “responding to *assessed risks of material misstatement*”, as long as a sentence is added in a prominent place in the application material to ISA 330.6 that auditors need not respond to risks of material misstatement that have been assessed as being acceptably low. Of course, the wording in paragraphs 45 to 52 and related application material would also need to be rephrased (other than in the case of risks at a financial statement level, this can be done using the concept of relevant assertions and “acceptably low level”).

(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?

We agree with the direction of the revised definition and related material for the determination of significant risks. However, as noted from our responses (a) to (d) above, the definition of significant risk should commence with "An identified inherent risk: …". Furthermore, in line with ISA 200, the term "acceptable level" in paragraph A10 needs to be changed to "acceptably low level". In addition, the words in A10 need to recognize the usage of "inherent risk" as set forth in our responses to (a) to (d) above. We refer to our response to (c) above in relation to our views on how significant risks are determined on the spectrum of inherent risk.

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 fact that in paragraph A207 the draft did not change the description of what a risk of material misstatement at the financial statement level is. However, given the importance of this description and the fact that it is required, we believe that this description should be moved to the definitions section of the standard. With respect to the requirements, from a process point of view it would make sense to do 47 (b) first to address overall responses prior to addressing the specific responses to address (a) because some overall responses will have an impact on the assessment of inherent or control risk in (a). For this reason, we would reverse the order of (a) and (b). Aside from the wording changes that would result from our responses to question 6 above, we found paragraph A216 to be difficult to understand and we believe that in the first bullet of A219 the phrase "risk of management misrepresentation" ought to be changed to "risk of material misstatement due to fraud", since this is the term normally used in the ISAs and the term "management misrepresentation" is currently undefined, even if it is currently used in one other place in the ISAs.

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?

We understand the stand-back in the draft to essentially represent an overall consideration as to whether any risks of material misstatement for material items in the financial statements have not been appropriately assessed based upon the information that the auditor has obtained. We think that in most cases, material items would have been assessed as having risks of material misstatement that are not acceptably low. However, the stand-back seems to make sense so that the auditor is led to rethink whether all the information received has been appropriately taken into account. We believe that this requirement is independent of whether or not the requirement in paragraph 18 of ISA 330 is retained.

However, we believe that paragraph 52 is not consistent with ISA 320.11. To take into account aggregation risk for the purposes of risk assessment, ISA 320.11 requires the auditor to use performance materiality – not materiality – for quantitative amounts in the financial statements. Consequently, 52 (a) in the draft needs to be rephrased as follows: "… disclosures that, if quantitative, exceed performance materiality, or are qualitatively material, and that…".

Appendix C: Conforming and Consequential Amendments

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

a) ISA 220 and ISA 240, are these appropriate to reflect the corresponding changes made in ISA 315 (Revised)?

We have no substantive comments on ISAs 200 and 240, other than those conforming amendments that would result from our comments on the draft of ISA 315.

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?

Our comments in relation to paragraph 18 of ISA 330 are provided in our response to paragraph 10 below. We note that conforming amendments to the wording of the draft of ISA 330 would result from our comments on the draft of ISA 315.

We agree with the other changes made to ISA 330 *with the exception of one fundamental issue, which is our greatest concern with this exposure draft* and which we address immediately below, and a few issues of lesser importance that we address thereafter.

Fundamental Issue

ISA 200 is clear in a number of paragraphs that in an audit an auditor is required to reduce audit risk to an acceptably low level. Since aggregation risk for amounts is addressed through performance materiality as required in ISA 320.11 and the aggregate effect of misstatements of disclosures is addressed through ISA 450.A4 & .A17 in connection with ISA 700.13 (d), this implies that audit risk must be reduced to an acceptably low level for the items depicted in the financial statements. This also implies that if an auditor assesses particular risks of material misstatement as being at an acceptably low level, unless paragraph 18 of extant ISA 330 applies, an auditor need not respond to those assessed risks of material misstatement with overall responses or further audit procedures.

However, paragraph 7 (a) of the draft of ISA 330 requires the auditor to consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each *significant* class of transactions, account balance, and disclosure. Since the draft of ISA 315.16 (j) defines a significant class of transactions, account balances or disclosure as one for which there is one or more relevant assertions, and relevant assertions are defined in ISA 315.16 (h) as those for which likelihood of a material misstatement that is more than remote, paragraph 7 (a) of ISA 330 as drafted effectively requires this consideration <u>regardless of the assessed risk of material misstatement</u> and requires such consideration for all significant classes of transactions, account balances and disclosures that contain a risk of material misstatement that is more than remote.

Even worse, paragraph 27 in effect requires the auditor to obtain sufficient appropriate audit evidence for all relevant assertions, which, given the definition of relevant assertions means for all assertions for which the auditor believes the risk of material misstatement is more than remote, <u>regardless of the assessed risk of material misstatement</u>.

There are two main concerns with this approach. First, the entire point of assessing the risks of material misstatement is to determine the nature and extent of responses needed to address the assessed risks. If the risk of material misstatement has been assessed as being acceptably low as described in ISA 200, there are no grounds for requiring any responses at all because none are needed: the objective of the audit to reduce audit risk to an acceptably low level has been achieved for that item. Second, by requiring responses for all relevant assertions as defined in the draft and hence for all risks of material misstatement that are more than remote, together with the application of the iterative approach as described in the drafts of ISAs 315 and 330, the draft of ISA 330 either

- violates ISA 200 by requiring auditors to reduce audit risk to a remote likelihood, rather than to an acceptably low level of risk, or
- changes the meaning of acceptably low level of risk to be equivalent to a remote likelihood and thereby changes the meaning of reasonable assurance, which is definitely beyond the scope of the Project Proposal upon which this exposure draft is based.

Furthermore, by requiring responses to risks of material misstatement regardless of the assessed risk of material misstatement and using the low threshold of a remote likelihood of risk, the draft of ISA 330 would generate a dramatic increase in the work effort currently required for audits – particularly for audits of financial statements of smaller and less complex entities. It would undermine the scalability of such audits. We do not believe that the additional assurance obtained will be worth the additional costs incurred.

Even if the definition of a relevant assertion were to be changed as we propose in our response to question 6 (d), while the effect on work effort would be less pronounced, the concerns we express in the two bullet points above would remain and we would still question whether the additional assurance obtained will be worth the additional costs incurred.

In our view, the wording in the draft of paragraph 7 (a) of ISA 330 can be changed to read as follows to ameliorate the issues we have noted:

> "Consider the reasons for the assessment given to each assessed risk of material misstatement at the assertion level…"

This implies deleting the reference to "significant class of transactions, account balances and disclosures", which is superfluous for the purposes of this requirement.

Accordingly, the wording of the draft of paragraph 27 of ISA 330 can be changed as follows:

> "If the auditor has not obtained sufficient appropriate evidence as to the assessed risk of material misstatement at assertion level, the auditor shall attempt …".

No reference to "relevant assertion" or "significant class of transactions, account balances and disclosures" is needed.

The related application material paragraphs would need to be amended accordingly.

As proposed in our response to question 6 (d) above, we believe that application material to paragraph 6 ought to be added to clarify that auditor need not respond to assessed risks of material misstatement that have been assessed as being at an acceptably low level.

Other Issues

In line with our response to question 6 (c), the words "material" or "and magnitude of" need to be deleted form paragraph 7 (a) (i) and A9 of the draft of ISA 330. Furthermore, since controls address inherent risk – not control risk – the newly inserted words in paragraph 7(a) (ii) "that address the risk of material misstatement" should either be deleted or the words "risk of material misstatement" need to be replaced with "inherent risk".

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

We have no substantive comments on the other ISAs as presented in Appendix 2, other than those conforming amendments that would result from our comments on the draft of ISA 315.

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

We have no substantive comments on ISA 540 as presented in the Supplement to this exposure draft, other than those conforming amendments that would result from our comments on the draft of ISA 315.

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

As we pointed out in our response to question 8, we believe that the requirement for a stand-back as proposed in the draft of ISA 315 is independent of whether or not paragraph 18 is retained. Different views have been expressed about whether extant paragraph 18 in ISA 330 is appropriate.

On the one hand, views have been expressed that paragraph 18 is not needed if an appropriate risk assessment has been performed in accordance with ISA 315: it undermines the view that appropriate application of ISA 315 leads to an appropriate risk assessment. Furthermore, the requirement could be addressed with any substantive procedures, which meant that it was not an onerous requirement, but it was not a particularly useful requirement either.

On the other hand, views have also been expressed that risk assessments are never perfect and paragraph 18 represents a final "backstop" for material items when risk assessments turn out to be incorrect after the fact. The requirement also involves consideration of the reputational risk for auditors, audits and auditing standards if no substantive procedures are performed on material items, but subsequent to issuance of audit reports material misstatements arise on such material items: it is difficult to explain to stakeholders subsequently why no substantive procedures had been performed or are not required to be performed on material items.

However, if the requirement is retained, we believe that the requirement is not in line with ISA 320.11, which requires auditors to determine performance materiality – not materiality – for quantitative amounts in the financial statements to take into account aggregation risk for the purpose of determining the nature, timing and extent of further audit procedures. Consequently, paragraph 18 in the draft of ISA 330 needs to be rephrased as follows: "… disclosures that, if quantitative, exceed performance materiality, or are qualitatively material".

Appendix D: Request for General Comments

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

(a) Translations – recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents note in reviewing the ED-315.

We have difficulty translating the use of the term “less formal” or less “formalized” in relation to the risk assessment process in paragraphs 29 and 31 (a) and in relation to the system of internal control in paragraph 32, as well as in the related application material paragraphs.

We found the reference to “less structured and simpler” as used, for example, in paragraph A93 to be more understandable and easier to translate and ask ourselves whether this description could be used instead of “formal” and “formalized”.

(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.

The draft represents not only a substantive revision, it also represents the greatest change in audit process since the original issuance of ISA 315 and ISA 330 around 2004. Not only will translation, and its due process, of such a lengthy standard require considerable time that can be measured in several months, the due process, including stakeholder outreach, will also likely require several months. Not to be underestimated is the impact on national standards and guidance for certain audits of financial statements that would also need to be aligned prior to making this standard effective. We are therefore looking at least a year for translation, due process and the impact upon other national standards. In addition, firm methodologies and other guidance, particularly those for mid-sized and smaller practices that are not members of the larger international networks cannot begin to be adjusted for the new standard until at least the translation process is complete. Furthermore, once the methodologies and other guidance have been adjusted, considerable training of firm partners and staff would be needed. We expect the adjustment of methodologies and guidance together with training to take another year.

For these reasons, we believe that an appropriate effective date for the standard would be for financial reporting periods beginning at least two years after the approval of a final ISA.