

ISA 315 (Revised)¹—Issues and Recommendations

Draft summary of the IAASB's discussions at its September 2016 meeting can be found in the Appendix II to this paper.

Objective of the IAASB Discussion

The objective of this agenda item is to obtain the Board's views on the ISA 315 (Revised) Task Force's views and recommendations related to various matters described in this paper.

I. Introduction and Background

1. During their respective September 2016 meetings, the IAASB and the IAASB Consultative Advisory Group (CAG) Representatives provided the ISA 315 (Revised) Task Force (the Task Force) with feedback on the following three issues and related Task Force recommendations:
 - (a) The components of internal control relevant to the audit (Section III of [Agenda Item 3-B](#) of the IAASB September 2016 meeting materials);
 - (b) Determination of significant risks (Section IV of **Agenda Item 3-B** of the IAASB September 2016 meeting materials); and
 - (c) A spectrum of risks (Section V of **Agenda Item 3-B** of the IAASB September 2016 meeting materials).

The draft decision summary of the significant matters discussed at the September 2016 IAASB meeting can be found in Appendix II to this paper.

2. Collectively, the feedback from the IAASB and CAG Representatives from their respective September 2016 meetings, as well as the feedback received from the International Federation of Accountants (IFAC) Small- and Medium-Sized Practices (SMP) Committee letter to the IAASB (the 'SMP Committee Feedback') is referred to herein as the 'feedback from the September 2016 meetings.'
3. Since the September 2016 IAASB meeting, outreach has been performed with the SMP Committee and the Forum of Firms through presentations at their respective October 2016 meetings, which included interactive dialogue with the participants at those meetings on issues related to ISA 315 (Revised). The Task Force Chair and Staff participated in a teleconference with the Data Analytics Working Group (DAWG) to discuss matters related to the ISA 315 (Revised) project and data analytics (see Section VII of this paper for further details). In December 2016, the Task Force Chair and Staff will participate in a video conference with staff and other representatives of the Nordic Federation of Public Accountants to discuss the insights learned from the responses to their consultation on [Nordic Standard for Audits of Small Entities](#).

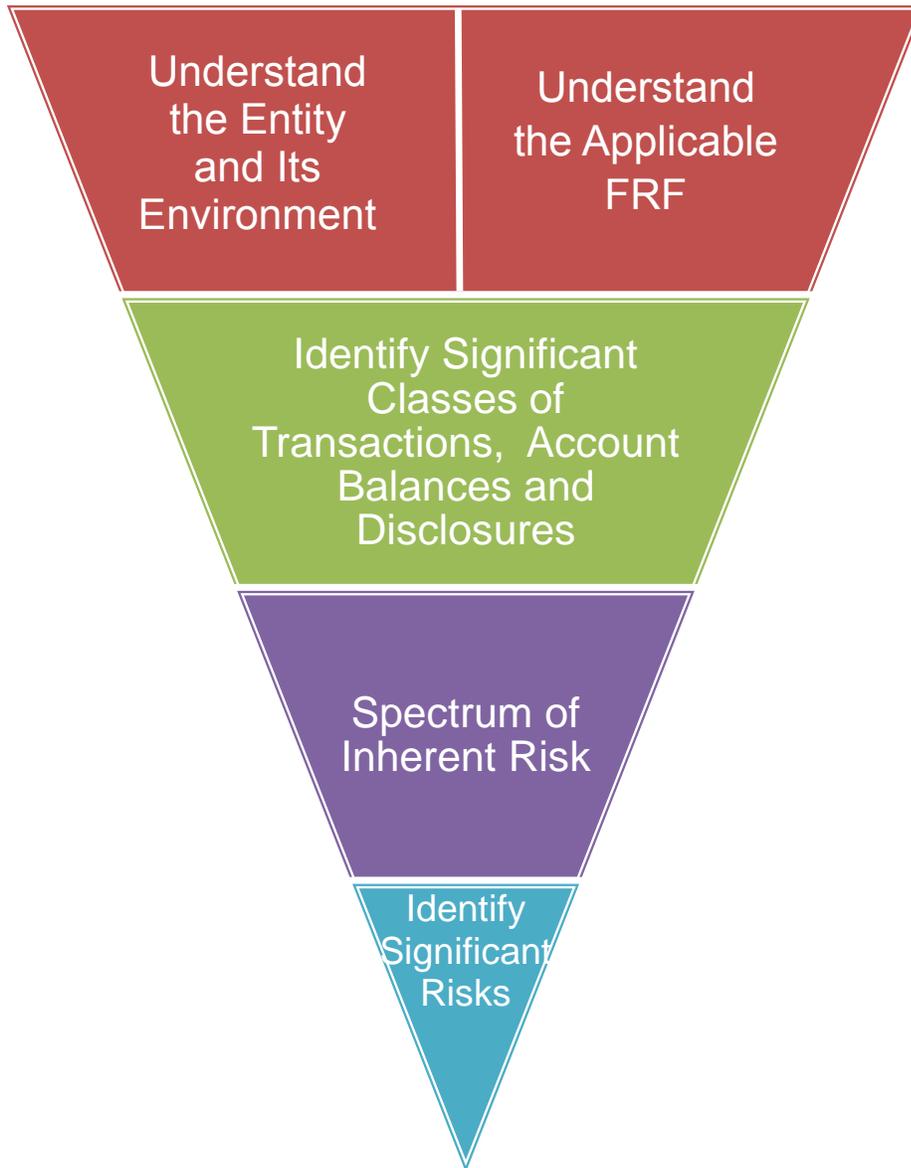
¹ International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

II. Issues Explored by the Task Force and Structure of this Paper

4. This paper explores issues and Task Force views and recommendations related to the following topics:
- (a) *Identification of inherent risks*—How the required understanding of the entity and its environment can more effectively result in the identification of inherent risks at the financial statement and assertion level. Specifically, whether (Section III, paragraphs 9–12):
 - (i) Further clarification is needed in ISA 315 (Revised) regarding the purpose of the auditor obtaining an understanding of the entity and its environment; and
 - (ii) More prominence should be given in ISA 315 (Revised) to the importance of the auditor obtaining an understanding of the applicable financial reporting framework (FRF).
 - (b) *Identifying significant classes of transactions, account balances and disclosures*—Exploring whether the introduction of the concept of the identification of significant classes of transactions, account balances and disclosures (similar to a concept that is used in the United States Public Company Accounting Oversight Board (PCAOB) standards) may assist auditors with identifying inherent risks at the assertion level, including assisting auditors with connecting inherent risks identified when obtaining an understanding of the entity and its environment to the relevant assertions (Section III, paragraphs 16–22).
 - (c) *Spectrum of risk*—Taking into account the feedback from the September 2016 meetings, further exploration of the explicit inclusion in ISA 315 (Revised) of a spectrum of risk and the use of qualitative inherent risk factors by the auditor in the identification and, in certain instances, assessment of inherent risks (Section IV, paragraphs 30–37).
 - (d) *Significant risks*—Further consideration relating to determining significant risks based on the feedback from the September 2016 meetings (Section IV, paragraphs 38–45).
 - (e) *Understanding of internal control*—Further consideration of matters relating to obtaining an understanding of internal control, specifically (Section V):
 - (i) An update on the Task Force discussions in light of the feedback from the September 2016 meetings on the purpose of the auditor obtaining an understanding of internal control and the relevance of the components of internal control to the audit; and
 - (ii) Initial Task Force views on issues related to the requirement in ISA 315 (Revised), paragraph 13, for the auditor to evaluate the design of those controls relevant to the audit and whether they have been implemented.
 - (f) Other matters discussed to date that the Task Force would like the IAASB's input on at this stage of the project (Section VI).

III. Identifying Inherent Risks, Including Significant Risks

Overview of Task Force Views and Recommendations Related to Identifying Inherent Risks



5. This diagram depicts the Task Force's views regarding the actions the auditor would undertake to identify inherent risks, including significant risks. Each of these aspects is discussed further in this paper. As an overview, the auditor obtains an understanding of the entity and its environment – based on the extant requirement, but with greater prominence given to understanding the applicable FRF. The auditor would use the understanding of the entity and its environment alongside the understanding of the applicable FRF to develop an expectation of the classes of transactions, account

balances and disclosures in the entity's financial statements and assist the auditor with the identification of inherent risks.² The auditor would then confirm their expectations by identifying the significant classes of transactions, account balances and disclosures, and their relevant assertions, in the entity's financial statements, assisting the auditor in identifying inherent risks at the assertion level. For the identified inherent risks, the auditor would determine which of the inherent risks are at the higher end of the spectrum of inherent risk, including those that the auditor determines to be significant risks. Throughout this process, the auditor will consider quantitative and qualitative risk factors in the context of the nature

² The Task Force is of the view that additional information relevant to inherent risks may also be gained through the auditor's obtaining an understanding of internal control (see Section V of this paper for further discussion).

and characteristics of the identified risks. With this overview in mind, the Task Force proposes to develop revisions to ISA 315 (Revised) that, in summary:

- (a) Give greater prominence to the requirement for the auditor to obtain an understanding of the applicable FRF and enhance how the auditor applies their understanding of the entity and its environment, alongside their understanding of the applicable FRF, to develop an expectation of the classes of transactions, account balances and disclosures in the entity’s financial statements (see paragraphs 9-12 of this paper).
 - (b) Explain that the qualitative inherent risk factors can be used by the auditor (see paragraphs 23–29 of this paper), in conjunction with the auditor’s understanding of the entity and the applicable FRF, in developing expectations about those areas of the financial statements that are susceptible to risks of material misstatement due to their nature (see paragraphs 13–15 of this paper).
 - (c) Require the auditor to identify “significant classes of transactions, account balances and disclosures” and their “relevant assertions” (see paragraphs 16–22 of this paper).
 - (d) Require the auditor to assess which of the identified inherent risks are at the higher end of the spectrum of inherent risk (see paragraphs 30–37 of this paper), clarifying that significant risks are inherent risks that fall on the highest end of the spectrum of inherent risk (see paragraphs 38–45 of this paper).
6. Accordingly, the possible changes relating to the auditor’s understanding of the entity and its environment (as summarized in paragraph 5 of this paper) in conjunction with the auditor’s understanding of the entity’s internal control, should be sufficient to enable the auditor to assess the risks of material misstatement. While the Task Force has not yet fully considered all aspects of ISA 315 (Revised) regarding the auditor’s understanding of internal control, the Task Force has further explored some aspects of this topic (see Section V of this paper).

Understanding the Entity and Its Environment



7. ISA 315 (Revised) paragraph 11 (see Table 1) includes requirements for the auditor to obtain an understanding of numerous aspects of the entity and its environment. As noted in the ISA 315 (Revised) Project Proposal,³ ISA 315 (Revised) contains minimal guidance on how auditors should use the information obtained in gaining an understanding of the entity and its environment.

Table 1. The Entity and Its Environment
ISA 315 (Revised) – Extant 11. The auditor shall obtain an understanding of the following: <ul style="list-style-type: none"> (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A24–A29) (b) The nature of the entity, including: <ul style="list-style-type: none"> (i) its operations; (ii) its ownership and governance structures;

³ The [ISA 315 \(Revised\) project proposal](#) was approved at the IAASB’s September 2016 meeting.

- (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
- (iv) the way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A30–A34)
- (c) The entity’s selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A35)
- (d) The entity’s objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A36–A42)
- (e) The measurement and review of the entity’s financial performance. (Ref: Para. A43–A48)

8. The Task Force has explored whether challenges with identifying (and assessing) risks of material misstatement result, at least in part, from a lack of clarity on how to apply and interpret the information gathered when obtaining an understanding of the entity and its environment. The Task Force is of the view that the requirement for the auditor to obtain an understanding of the entity and its environment is for the auditor to gather information regarding risks that may give rise to inherent risks, and therefore may impact the auditor’s assessment of inherent risk (or risk of material misstatement, when a separate assessment of inherent risk is not performed) at the financial statement and assertion level. The Task Force refers to the auditor’s procedures to address the requirement to obtain an understanding of the entity and its environment as the “top-down” approach to identifying inherent risks.

Greater Prominence on Understanding the Applicable Financial Reporting Framework

9. The auditor’s opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable FRF. Accordingly, understanding the requirements of the applicable FRF in order to consider how those requirements may affect the risks of material misstatement of the entity’s financial statements is important to the audit, yet it is not a particularly prominent aspect of paragraph 11 of ISA 315 (Revised). In addition, the Task Force is of the view that the auditor should use their understanding of the applicable FRF alongside the auditor’s understanding of the entity and its environment to develop an understanding and an expectation of what information should be communicated in the financial statements and areas in the financial statements where misstatements are likely to arise (i.e., develop an expectation regarding the contents of the entity’s financial statements, including many of the classes of transactions, account balances and disclosures, and potential related risks). However, the Task Force is of the view that this is not sufficiently explained in ISA 315 (Revised) and recommends the development of enhancements to the standard in this respect.
10. When the Task Force began exploring how the applicable FRF might be made more prominent in the requirements in paragraph 11 of ISA 315 (Revised),⁴ the Task Force noted that paragraph 45 of ISRE 2400⁵ (shown below with underlining added for emphasis) takes the same approach as the Task Force is



⁴ Paragraph 11(a) of ISA 315 (Revised) currently includes obtaining an understanding of the applicable FRF.

⁵ International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Historical Financial Statements*

recommending (i.e., is an example of treating the understanding of the applicable FRF as being distinct from the environment in which the entity is operating):

“The practitioner shall obtain an understanding of the entity and its environment, and the applicable financial reporting framework, to identify areas in the financial statements where material misstatements are likely to arise and thereby provide a basis for designing procedures to address those areas.”

11. The Task Force is of the initial view that adding greater emphasis to the requirement to understand the applicable FRF and clarifying its importance to the risk assessment process might be achieved by moving the extant requirement to obtain an understanding of the applicable FRF out of paragraph 11(a) of ISA 315 (Revised) and into its own separate paragraph under paragraph 11 of the standard. The Task Force will however continue to consider its re-positioning (e.g., possibly as a separate paragraph under paragraph 11 of ISA 315 (Revised) or integrating it into extant paragraph 11(c) of the standard).
12. In addition, the Task Force is of the view that the hanging text at the end of paragraph 11(b) of ISA 315 (Revised) “to enable the auditor to understand the classes of transactions, account balances and disclosures to be expected in the financial statements” should be moved to the introductory part of paragraph 11. Doing so would enhance all aspects of the required understanding (including the applicable FRF) and not just those noted in paragraph 11(b) of ISA 315 (Revised).

Applying the Qualitative Inherent Risk Factors in Obtaining an Understanding of the Entity and Its Environment, and the Applicable FRF

13. The Task Force is of the view that the auditor’s consideration of the qualitative inherent risk factors presented at the September 2016 meetings (and further addressed in paragraph 28 of this paper) during the process of the auditor obtaining an understanding of the entity and the applicable FRF, can assist the auditor in performing more robust risk assessment procedures at this initial stage of the auditor’s risk assessment process.
14. The qualitative inherent risk factors can be used by the auditor to develop expectations about those areas of the financial statements that are susceptible to risks of material misstatement. By considering these risk factors in the context of the requirements of the applicable FRF, the auditor should be able to develop expectations about the respective degree of complexity, ambiguity, change, uncertainty and susceptibility to fraud inherent in the classes of transactions, account balances and disclosures expected to be in the entity’s financial statements. Further, by understanding changes in the requirements of the applicable FRF, the auditor can develop expectations about implications for the entity’s financial statements. Similarly, changes in the entity could result in expectations for changes in how the requirements of the applicable FRF are applied to the entity’s financial statements. These expectations would form the outcome of the auditor’s work to understand the entity and its environment, and the applicable FRF, and would be the initial source of the auditor’s identification of inherent risks.
15. The Task Force recommends developing guidance for the application of the qualitative inherent risk factors in the auditor’s obtaining an understanding of the entity and its environment as well as the auditor’s obtaining an understanding of the applicable FRF.



Matters for IAASB Consideration

1. Do IAASB members agree with Task Force views and recommendations in paragraphs 9–12 of this paper related to giving greater prominence to the understanding of the applicable FRF in the requirements in extant paragraph 11 of ISA 315 (Revised)? IAASB members are asked to share their views as to why they do or do not agree.
2. Do IAASB members agree with the Task Force views expressed in paragraphs 13–15 of this paper related to clarifying how the use of the qualitative inherent risk factors assists in identifying inherent risks related to the classes of transactions, account balances and disclosures expected to be in the entity's financial statements? IAASB members are asked to share their views as to why they do or do not agree.

The Identification of Significant Classes of Transactions, Account Balances and Disclosures and Relevant Assertions

16. Once the auditor has developed an expectation of the contents of the entity's financial statements (as described above), the Task Force is of the view that there is benefit to validating that expectation by identifying the "significant classes of transactions, account balances and disclosures and their relevant assertions" in the entity's financial statements. The Task Force discussions to date have noted that in practice (and in the PCAOB's risk assessment standards), in addition to the "top-down approach" to the identification of inherent risks discussed in paragraphs 9–15 of this paper, the identification of inherent risks may also have a "bottom-up" approach whereby the amounts and disclosures in the financial statements are used to identify those classes of transactions, account balances and disclosures and their relevant assertions susceptible to material misstatement.
17. Drawing on a similar requirement in paragraph 59(e) (and related paragraph 60) in PCAOB AS 12⁶ (see Appendix I for relevant extracts from PCAOB AS 12), the Task Force is of the view that a new requirement to identify the "significant classes of transactions, account balances and disclosures and their relevant assertions" would be helpful both in creating a link between the inherent risks identified as part of the auditor's understanding of the entity and its environment and the auditor's understanding of the applicable FRF to relevant assertions and further identifying inherent risks that are specific to the classes of transactions, account balances and disclosures in the entity's financial statements. Task Force members who have experience with audits where the PCAOB's standards are applied have noted these benefits are realized in practice.
18. In the context of extant ISA 315 (Revised), identification of "significant classes of transactions, account balances and disclosures and their relevant assertions" could help auditors better understand and apply the requirement in paragraph 26(a) of ISA 315 (Revised) to identify risks of material misstatement "...by considering the classes of transactions, account balances, and disclosures in the financial statements."



⁶ Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*

The Task Force notes that it may help auditors in further understanding what is applicable in a similar reference in the requirement in paragraph 20 of ISA 315 (Revised) (emphasis added):

“An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.”

19. Paragraph 59(e) of PCAOB AS 12 requires the auditor, in identifying and assessing risks of material misstatement, to identify “significant accounts and disclosures and their relevant assertions.” Additional guidance related to paragraph 59(e) of PCAOB AS 12 notes that:

- An account or disclosure is significant based on its susceptibility to material misstatement;
- The susceptibility to material misstatement is judged both in terms of quantitative measures as well as qualitative factors; and
- The determination is based on inherent risk, without regard to the effect of controls.

Paragraph 60 of PCAOB AS 12 (see Appendix I) contains risk factors relevant to the identification of significant accounts and disclosures that comprise both qualitative inherent risk factors (similar to the qualitative inherent risk factors that the Task Force has identified (see discussion in paragraph 28 of this paper) and quantitative measures.

20. The Task Force is of the view that the identification of significant classes of transactions, account balances and disclosures would provide auditors with a more robust framework for the requirements in ISA 315 (Revised) to identify and assess risks of material misstatement.⁷ Task Force members familiar with the PCAOB requirements for the formal identification of significant accounts and disclosures (the equivalent of significant classes of transactions, account balances and disclosures) have noted that in practice it creates essentially what can be viewed as a “backbone” for the risk assessment process. This “backbone” facilitates the auditor connecting both the inherent risks identified from the “top-down” procedures of obtaining an understanding of the entity and its environment and the applicable FRF, as well as those from the “bottom-up” consideration of inherent risks at the individual class of transactions, account balance and disclosure level, to their relevant assertions. This in turn enhances the auditor’s determination of the nature, timing and extent of further audit procedures that are both responsive to the risk assessments at the assertion level and necessary to obtain sufficient appropriate audit evidence.

21. The Task Force is of the preliminary view that, if the IAASB is in agreement with the recommendation to include in ISA 315 (Revised) the requirement to identify significant classes of transactions, account balances and disclosures, the auditor should consider a combination of quantitative and qualitative risk factors in identifying them. The Task Force would develop guidance relating to relevant qualitative and quantitative factors that should be taken into account. The Task Force is of the view that the qualitative inherent risk factors in paragraph 28 of this paper would be used as the basis for the risk factors that the auditor would need to consider for the qualitative aspect of identifying significant classes of transactions,

⁷ ISA 315 (Revised), *paragraph 25*. Additional guidance regarding risks of material misstatement is included in paragraph 13(n) of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. Paragraph 13(n) of ISA 200 defines inherent risk (underline added for emphasis) as “the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.”

account balances and disclosures. Determining the quantitative aspects would be the subject of further discussion by the Task Force (having regard to quantitative-related factors highlighted in PCAOB AS 12 paragraph 60 – see paragraph 19 of this paper)).

22. The Task Force also noted that a concept similar to “significant classes of transactions, account balances and disclosures” is applied in the requirement in paragraph 18 in ISA 330.⁸ That paragraph states “irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.” The Task Force discussed feedback that the concept of “material classes of transactions, account balances, and disclosures” was often difficult to interpret, primarily because the concept of materiality in the ISAs is described in the context of misstatements and not in the context of financial statement items. It is difficult to explain what materiality means in this context. The Task Force considered that “significant classes of transactions, account balances and disclosures” may be easier to apply because it would, as noted above, be based on the consideration of both quantitative and qualitative risk factors. In effect it would clarify that such items are those where there is a greater likelihood of material misstatement. The Task Force therefore intends to consider whether the reference to “material class of transactions, account balance and disclosure” in ISA 330 paragraph 18 should be replaced with “significant classes of transactions, account balances and disclosures,” subject to Board feedback.

Matters for IAASB Consideration

3. Do IAASB members agree with the Task Force’s recommendation to require the auditor to determine significant classes of transactions, account balances and disclosures and their relevant assertions for the purpose of identifying inherent risks at the assertion level? IAASB members are asked to share their views as to why they do or do not agree.
4. Do IAASB members agree with the Task Force’s recommendation in paragraph 22 of this paper? IAASB members are asked to share their views as to why they do or do not agree.

Qualitative Inherent Risk Factors for the Identification of Inherent Risks

23. As noted in paragraphs 13–15, 19 and 21 of this paper, the Task Force continues to take the view that, in identifying risks of material misstatement, the qualitative inherent risk factors discussed at the IAASB’s September 2016 meeting would assist the auditor in identifying inherent risks. The feedback from the September 2016 meetings was supportive of the Task Force continuing to explore these factors but to consider whether and, if so, how risks relating to fraud, management bias and data would be covered by the four qualitative inherent risk factors presented.
24. The Task Force specifically considered whether susceptibility to fraud should be added to the qualitative inherent risk factors. The Task Force recognized that fraud risk is outside the control of the entity (though may be perpetrated by management or employees) and concluded that it is a qualitative inherent risk factor, and therefore is recommending adding ‘the susceptibility to fraud’ to the qualitative inherent risk factors (see paragraph 28 of this paper). The Task Force also noted that this was consistent with the treatment of fraud risks as significant risks (since significant risks are inherent risks). The Task Force also



⁸ ISA 330, *The Auditor’s Responses to Assessed Risks*

noted that ISA 240⁹ defines fraud risk factors as “events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud”¹⁰ and also identifies another factor that is often present in cases of fraud – the ability of the perpetrator to rationalize the fraud.

25. In determining whether susceptibility to fraud should be an additional factor, the Task Force considered whether some or all of the qualitative inherent risk factors presented during the September 2016 meetings (complexity, ambiguity, change and uncertainty) would also be present in circumstances where fraud risk factors were indicated. The Task Force concluded that there was likely to be some correlation between the presence of fraud risk factors and at least some of the other qualitative inherent risk factors because these other factors often provide an opportunity to commit fraud. However, the Task Force considered that, despite such correlation (and therefore some overlap) between these factors (complexity, ambiguity, change and uncertainty) and fraud risk factors, it would be appropriate for the auditor to specifically consider susceptibility to fraud (i.e. fraud risk factors) as an additional qualitative inherent risk factor.
26. The Task Force also specifically considered whether risks relating to management bias and data risk should be identified as separate qualitative inherent risk factors or whether the other factors would address circumstances where such risks would be indicated. With respect to management bias, the Task Force is of the view that intentional management bias is possible when management judgment is required to determine the information required to be included in the financial statements due to ambiguity (a degree of vagueness or a lack of clarity) in the applicable requirements. The Task Force therefore considered that management bias would generally be more likely when ambiguity was indicated and that management bias could be addressed through describing the nature of the risks that could be indicated when ambiguity is identified.
27. In relation to risks relating to data, the Task Force’s preliminary view was that these risks would not need to be identified through a separate inherent risk factor because data risks would likely be indicated by the presence of one or more of the other identified factors. For example, when a method is required to be applied in making a significant estimate that is complex because it requires multiple sources of large volumes of data, this could indicate risks to data integrity, particularly when such data would need to be sourced either internally from systems outside of the general and subsidiary ledgers or from external parties. However, the Task Force plans to further explore risks relating to data at its December 2016 Task Force meeting where the topic of risks related to information technology (IT) will also be discussed.
28. The Task Force has therefore now identified five qualitative inherent risk factors, which include the four factors discussed with the IAASB at its September 2016 meeting as well as susceptibility to fraud (see paragraphs 24–25 of this paper and (e) below), which are described as follows:
 - (a) Complexity: arises when there are many items or relationships among such items that require integration in applying depiction methods to determine information required by the FRF (e.g., using a complex model to determine a fair value, complex patterns of trading in financial instruments or complex supplier relationships for a retailer).
 - (b) Ambiguity: that results from a lack of clarity or a degree of vagueness in exactly what is required by the FRF, resolved by making an election or judgment about the appropriate information to include. Where the matter is more subjective, the judgment may be more susceptible to management bias.

⁹ ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

¹⁰ ISA 240, paragraph 11(b)

- (c) Change: that results in changes in the information required by the FRF from one point in time to another during or between financial reporting periods – this includes changes in the FRF or in the entity or its business model or in the environment in which the entity operates.
 - (d) Uncertainty: that arises from circumstances not within the control of the preparer of the financial information and that affect the determination of information required by the FRF and relate to the past, present or future condition of a transaction or event.
 - (e) Susceptibility to Fraud: that results from fraud risk factors and is a quality or state of being susceptible to misappropriation of the entity's assets or fraudulent financial reporting within the context of the FRF, including being susceptible to management override of control.
29. The qualitative inherent risk factors in paragraph 28 of this paper generally encompass the qualitative risk factors relevant to the identification of significant accounts and disclosures included in paragraph 60 of PCAOB AS 12 (see paragraph 19 of this paper).

Matter for IAASB Consideration

5. Do IAASB members agree with the addition of the susceptibility to fraud as a fifth qualitative inherent risk factor (as described in paragraphs 24–25 and 28 of this paper)? IAASB members are asked to share their views as to why they do or do not agree.

IV. Spectrum of Risk and Significant Risk

Spectrum of Risk

30. After exploring the process for the identification of inherent risks, the Task Force considered how the inherent risks identified relate to the concept of the spectrum of risk and the determination of significant risks, taking into consideration the feedback from the September 2016 meetings.
31. Feedback from the September 2016 meetings showed support for the Task Force continuing to explore the explicit inclusion in ISA 315 (Revised) of a spectrum of risk. The Board did caution the Task Force to not introduce unnecessary additional complexity, noting that the explicit introduction in ISA 315 (Revised) of the concept of a spectrum of risk should not result in ISA 315 (Revised) requiring a number of risk categories (other than what is already in the standard regarding significant risk).
32. A question was raised at the IAASB meeting regarding whether the explicit reference to a spectrum of risk would achieve anything within ISA 315 (Revised), as the auditor's response to assessed risks is addressed in ISA 330. In response, some Board members expressed the view that having a more explicit acknowledgment of the spectrum of risk in ISA 315 (Revised) would help auditors tailor responses under ISA 330. In addition, it was noted that in practice, a spectrum of risk could address the observation that a major portion of the auditor's resources are focused on responding to significant risks at the expense of those risks of material misstatement that are not determined to be a significant risk.



Task Force Views – Spectrum of Inherent Risk

33. The Task Force's discussions to date have included that the qualitative inherent risk factors in paragraph 28 of this paper would be useful to the auditor in the identification of inherent risks (see paragraphs 13–15, 19, 21 and 23 of this paper). The Task Force further believes the qualitative inherent risk factors can

also be useful in the assessment of inherent risks (at a minimum as it relates to determining significant risks). Specifically, the qualitative inherent risk factors can be used by the auditor to put into context the information obtained from risk assessment procedures to determine the extent to which an assertion is affected by one or a combination of the factors.

34. The risk assessment procedures performed by the auditor (understanding the applicable FRF, the entity and its environment and the entity's internal control)¹¹ provide a basis for the auditor's identification of inherent risks. If inherent risks were individually assessed, these would fall on a spectrum of inherent risks that would include a range from the lowest to the highest inherent risk, with the highest inherent risks being those determined to be significant risks. The Task Force is not suggesting that the auditor be required to make an assessment of where each inherent risk is on the spectrum of inherent risk. Instead, the Task Force is of the view that the auditor should perform an assessment of which of the inherent risks are at the higher end of the spectrum of inherent risks (consistent with extant 315 (Revised)), for the purposes of identifying:
- (a) Inherent risks that the auditor determines to be significant risks (see paragraphs 38–45 of this paper); and
 - (b) Higher inherent risks, being those that are at the higher end of the spectrum of inherent risk but below those that are determined to be significant risks or have other characteristics, that the auditor determines (based on the auditor's judgment) it necessary to obtain an understanding of the control activities associated with that inherent risk (see discussion in Table 3).
35. The assessment of the identified inherent risks that fall at the higher end of the spectrum of inherent risk would be performed by taking into consideration the impact of the qualitative inherent risk factors, in addition to the likelihood and magnitude of the risk of misstatement.
36. The Task Force is of the view that explicit reference in ISA 315 (Revised) to a spectrum of inherent risk would assist the auditor with the identification of those risks noted in paragraph 34 of this paper. This will also address comments made by a CAG Representative that the concept of significant risk does not mean that those risks that are not significant risks are automatically low risk.

Task Force Recommendation

37. The Task Force, in responding to the feedback from the September 2016 meetings and in considering the views of the Task Force expressed above, recommends the:
- (a) Inclusion in ISA 315 (Revised) of explicit reference to a spectrum of inherent risk, supported by application material to explain the intent of a spectrum of inherent risk. Recognition of a spectrum of inherent risk in ISA 315 (Revised) would be for the purposes of the auditor's determination of significant risks and whether, in the auditor's judgment, it may be necessary to obtain an understanding of the control activities associated with that inherent risk (see further discussion of this aspect in the Control Activities section of Table 3 in this paper). Further consideration will be given to how the spectrum of inherent risk relates to the risk assessment discussions in the ISA 540¹² project.

¹¹ The Task Force is of the view that additional information relevant to inherent risks may also be gained through the auditor's obtaining an understanding of internal control (see Section V of this paper for further discussion).

¹² ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

- (b) Development of application material to illustrate examples of risks on the spectrum of inherent risk. This application material will include guidance to assist the auditor with making judgments regarding where on the spectrum the respective risk is and to clarify that if an inherent risk is not identified as a significant risk it is not by default considered to be low risk.

Matter for IAASB Consideration

6. Do IAASB members agree with the Task Force recommendations in paragraph 37 of this paper? IAASB members are asked to share their views as to why they do or do not agree.

Significant Risk

Determination of Significant Risks

38. Feedback from the September 2016 meetings was that the concept of significant risk should be retained, and that significant risk should continue to be a subset of the population of inherent risks. While supportive of the Task Force's efforts to bring clarity and consistency to the process of the determination of significant risks, the feedback from the September 2016 meetings was generally not supportive of the Task Force's proposed two filters to assist in the determination of significant risks.
39. The filters that had been recommended by the task force were "difficult for management to control" and "management does not or fails to control." Feedback from the September 2016 meetings was that it wasn't clear how the two filters would work together in practice without creating additional complexity, nor how the two filters would interrelate and work with the qualitative inherent risk factors (paragraph 28 of this paper). In addition, various IAASB members expressed the view that the second filter (management does not or fails to control) is delving into control risk and that would mean that significant risks would not be a subset of inherent risk completely.
40. Other feedback from the September 2016 meetings included:
- Retaining auditor judgment in the determination of significant risks, and not having the ISAs specify issues that should automatically be considered significant risks in every audit (other than what is currently in the ISAs for fraud risks related to management override of controls and revenue recognition);
 - Keeping in mind the factors that are in paragraph 28 of ISA 315 (Revised) (see Appendix I of this paper) as these continue to remain relevant in the auditor exercising judgment in considering which risks are significant risks; and
 - Exploring further how the application of the proposed filters would work with fraud risks, particularly that fraud risk is presumed under the ISAs to be a significant risk.



Task Force Views – Determination of Significant Risks

41. In considering the feedback from the September 2016 meetings, the Task Force is of the view that the two filters process for the determination of significant risks would not have the intended effect of bringing clarity and consistency to the determination of significant risks, and therefore is no longer considering this approach.

42. As noted above in the discussion regarding the spectrum of inherent risk, the Task Force is of the view that significant risks will be those risks that are the highest inherent risks in the spectrum of inherent risks. Taking into account the likelihood and magnitude of the risk, and applying the qualitative inherent risk factors in identifying and assessing risk, the auditor would make an assessment as to which of those inherent risks are at the highest end of the spectrum of risk (being those risks that have one or more of the qualitative risk factors having a high risk of misstatement). These would therefore be the significant risks. The Task Force is of the view that this would provide the basis for the definition of significant risks (i.e., significant risks being redefined in light of the nature of the risk of misstatement as a result of the significance of one, or a combination of, the qualitative inherent risk factors as well as in terms of the relative likelihood and magnitude of misstatement).
43. While there was less favorable support for the filter related to “management does not or fails to control,” the concept of “difficult for management to control” and understanding the reasons why a particular risk was “difficult for management to control” resonated with some IAASB members and was viewed by the Task Force as a concept it would continue to explore. Taking into account the Task Force view in paragraph 42 of this paper, the Task Force still believes that in essence, the nature of the items (based on the presence of one or a combination of the qualitative inherent risk factors) that will be assessed at the highest end of the spectrum will be those are that are “difficult for the entity to control.” As a result, the Task Force is of the view there may continue to be merit in retaining the concept of “difficult for the entity to control” either as part of the definition of significant risk or as application material in explaining the nature of a significant risk.

Definition of Significant Risk

44. Feedback from the September 2016 meetings noted agreement that the definition of significant risk is circular and that the Task Force should explore revising the definition with a focus on the nature of the risk.
45. The Task Force’s initial considerations and views related to the definition of significant risk include:
- The business dictionary defines significant risk as high-probability risk likely to have a significant impact (support for reference to likelihood and magnitude in the definition);
 - The determination of significant risk should be based on the relative likelihood and magnitude of misstatement and on the nature of the risk in the context of the qualitative inherent risk factors (i.e., a high inherent risk driven by the relative likelihood and magnitude of misstatement and one or a combination of the qualitative inherent risks factors discussed in paragraph 28 of this paper);
 - The definition of significant risk (or related application material) should include the concept of risks that are “difficult for the entity to control;” and
 - Whether the definition should continue to make reference to risks of material misstatement, or whether this should be changed to refer to inherent risks.

The Task Force will continue its discussions related to the definition of significant risk taking into account the feedback from the IAASB at its December 2016 meeting.

Matters for IAASB Consideration

7. IAASB members are asked to provide their views on the Task Force's recommendations, specifically whether the IAASB agrees with the recommendations:
 - (a) To incorporate the concepts of likelihood and magnitude and the qualitative inherent risk factors in the definition of significant risk?
 - (b) In the context of the introduction of a spectrum of inherent risk, whether the definition of significant risks should explicitly reference inherent risk?
 - (c) To incorporate reference to the concept of "difficult for the entity to control", either as part of the definition of significant risk or as application material in explaining the nature of a significant risk?

V. Understanding of Internal Control

The Entity's Internal Control

The Purpose of the Auditor Obtaining an Understanding of Internal Control

Feedback from the September 2016 meetings

46. Although there was overall support for Task Force efforts to clarify the purpose of the auditor obtaining an understanding of internal control, the feedback from the September 2016 meetings related to the Task Force views in this regard was mixed.
47. CAG Representatives and the SMP Committee agreed that obtaining an understanding of internal control can inform the auditor's identification of inherent risk, in addition to supporting the auditor's assessment of control risk and the design of further audit procedures. CAG Representatives cautioned the Task Force not to blur the lines between inherent risk and control risk when explaining these matters.
48. The IAASB agreed that understanding controls may assist the auditor in identifying inherent risks (because the nature and extent of the controls implemented may highlight risks that the auditor had not otherwise identified) but did not agree that this should be addressed by further clarifying the purpose for obtaining an understanding of internal control in the standard. Board members commented that clarifying the purpose in this manner could imply that the auditor always needed to understand controls for this purpose, whereas this should be a matter of judgment in the circumstances.
49. It was suggested that the Task Force's recommendation that an additional purpose of understanding internal control might be better expressed in a manner that focuses on the auditor considering when it may be appropriate, in their judgment, to understand controls, as they may be able to learn from how the entity has attempted to control the identified inherent risk.

Task Force Views – The Purpose of the Auditor Obtaining an Understanding of Internal Control

50. The Task Force has taken into account the feedback from the September 2016 meetings and further explored the relationship of the auditor's understanding of internal control to the auditor's identification and assessment of the risks of material misstatement.

51. Paragraph 6(b) of ISA 210¹³ states that “the auditor shall obtain the agreement of management that it acknowledges and understands its responsibility:
- (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
 - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;
 - (iii) ...”

This highlights the importance of internal control in the context of an audit because the ISAs establish that management acknowledges and understands its responsibility for internal control as a pre-condition to acceptance of an audit.

52. The Task Force notes that paragraph 12 of ISA 315 (Revised) states that (see Table 2 for full wording of paragraph 12):

“The auditor shall obtain an understanding of internal control relevant to the audit. ... It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit”.

Paragraph A49 (supporting application material to paragraph 12) further explains that:

“An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.”

53. The Task Force believes that paragraphs 12 and A49 of ISA 315 (Revised) provide the overarching framework for the auditor’s understanding of internal control relevant to the audit and from this understanding, the auditor may identify factors that affect inherent risk or control risk. That is, the understanding of internal control provides insights into the risks that management is controlling, as well as information about how management controls them. This understanding is therefore foundational to the auditor’s ability to identify the risks of material misstatement in the financial statements.
54. Further, “controls relevant to the audit” has been raised as a concept in need of clarification, particularly as it relates to how the auditor determines the controls relevant to the audit. The Task Force view is that, building from the principle in paragraph A49 of ISA 315 (Revised), “controls relevant to audit” consist of essentially those controls that the auditor needs to understand in order to facilitate the auditor’s identification of the risks of material misstatement in the financial statements. Accordingly, ISA 315 (Revised) includes a number of specific requirements that prescribe aspects of internal control or of components of internal control, that the auditor is required to obtain an understanding of, as well as circumstances in which obtaining an understanding of a component of internal control or particular controls is required.
55. The Task Force believes that, with respect to expressing the potential assistance that obtaining an understanding of internal control can provide in relation to the identification of the risks of material misstatement, including inherent risk, this would best be expressed as application material to support the auditor’s judgment under paragraph 12 of ISA 315 (Revised).

¹³ ISA 210, *Agreeing the Terms of Audit Engagements*

Task Force Recommendations

56. The Task Force has taken into account the feedback from the September 2016 meetings and recommends that a number of clarifications be made in ISA 315 (Revised) related to the purpose of the auditor obtaining an understanding of internal control. These clarifications can be summarized as follows:
- (a) The risk assessment process required by ISA 315 (Revised) involves both the identification and assessment of risks of material misstatement which can be performed by the auditor together or separately. Obtaining an understanding of the FRF, the entity and its environment and internal control are all necessary inputs to the auditor’s identification of risks of material misstatement.
 - (b) Paragraph 12 of extant ISA 315 (Revised) provides the overarching framework for the auditor’s understanding of internal control relevant to the audit and that from the understanding of internal control, the auditor may identify factors that affect inherent risk or control risk.
 - (c) While the auditor may make separate or combined assessments of inherent risk and control risk,¹⁴ it is the assessment of inherent risk that is most important in understanding the work that needs to be performed to respond to identified risk. As explained in paragraph 34 of this paper, the auditor’s understanding of inherent risk informs the identification of significant risks and other risks for which the auditor may determine (based on the auditor’s judgement) obtaining an understanding of control activities may be necessary. By understanding the relative placement of inherent risks on the spectrum, the auditor is able to make better informed decisions about the further audit procedures to be performed.

The Task Force intends to develop guidance respecting to the cautionary comments received in the September 2016 meetings to avoid blurring the lines between inherent and control risk. The Task Force will also continue to consider clarifications to the concept of “controls relevant to the audit” in conjunction with its enhancements related to understanding the components of internal control as discussed in the next section.

Matter for IAASB Consideration

8. Do IAASB members agree with Task Force’s recommended clarifications in paragraph 56 of this paper? IAASB members are asked to share their views as to why they do or do not agree.

Internal Control Relevant to the Audit

57. Feedback from the September 2016 meetings indicated support for the Task Force view that it is important for there to be a clear link between the overarching requirement to understand internal control relevant to the audit in paragraph 12 of ISA 315 (Revised), and the requirements related to the auditor obtaining that understanding for each of the individual components of internal control relevant to the audit (paragraphs 14 to 24 of ISA 315 (Revised)). The IAASB also supported the Task Force’s recommendation to clarify what is meant by the phrase “relevant to the audit” (see also paragraph 54 of this paper) within ISA 315 (Revised). See Table 3 for further discussion of Task Force views and recommendations regarding the relevance of each of the components of internal control relevant to the audit.

¹⁴ ISA 200, paragraph A40

Task Force Views and Recommendations – Internal Control Relevant to the Audit

Table 2. Obtaining an Understanding of Internal Control Relevant to the Audit

ISA 315 (Revised) – Extant

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A50–A73)

Task Force Recommendations

To address the feedback from the September 2016 meetings regarding the need for a closer link between paragraph 12 and paragraphs 14–24, the Task Force recommends the following revisions to paragraph 12 of ISA 315 (Revised):

12. The auditor shall obtain an understanding of internal control relevant to the audit through obtaining an understanding of the components of internal control in accordance with paragraphs 14 to 24 of this ISA. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A50–A73)

The Task Force is of the view that the suggested insertion to the requirement, along with additional application material, will clarify that:

- The requirements in paragraphs 14 to 24 of ISA 315 (Revised) inform the auditor how to meet the requirement in paragraph 12 of ISA 315 (Revised) to obtain an understanding of internal control relevant to the audit; and
- The auditor may not bypass the requirements in paragraphs 14 to 24 of ISA 315 (Revised) because they have made an initial assessment that primarily a substantive approach to the audit will be taken and that no controls are relevant to the audit.

Matter for IAASB Consideration

9. Do IAASB members agree with the Task Force recommendations to revise paragraph 12 of ISA 315 (Revised) as indicated and for the reasons noted in Table 2? IAASB members are asked to share their views as to why they do or do not agree.

Components of Internal Control

58. Feedback from the September 2016 meetings noted support for the Task Force continuing to explore scalability in the requirements for the auditor to obtain an understanding of internal control. The IAASB was of the view that the five components of internal control are interlinked and were therefore not supportive of the Task Force view that some components of internal control are always relevant to the audit and that other components of internal control may not always be relevant to the audit. Board

members noted a preference for keeping the components of internal control “wrapped” together and rather to make it clear in ISA 315 (Revised) (either through the requirements or in application material) that in an audit of a small or medium sized entity, the auditor would ordinarily be able to obtain an understanding of internal control relevant to the audit relatively quickly, whereas in a larger entity the auditor would need to do more to obtain the appropriate understanding.

59. CAG Representatives views’ in this area were mixed. One view noted was that the auditor is required to understand internal control sufficient to assess risks of material misstatement and plan the audit and, as a result, it is not clear whether the requirement to obtain an understanding of internal control relevant to the audit lends itself to being able to obtain less understanding or more understanding. The extent of the understanding of internal control needed to meet the objective of the standard is, and should continue to be, an area of judgment for the auditor. Another view expressed was that there may be circumstances where one or more of the components of internal control would not be relevant to the audit (e.g., the auditor may determine that it is more efficient to audit around the information system and therefore obtaining an understanding of the information system may not be necessary in those situations).
60. The SMP Committee was in agreement with requiring auditors to consider all five components of internal control (if they exist) and to require the auditor to obtain an understanding of each of them, to the extent that each of them is relevant to the audit.
61. Taking into account the feedback received from the September 2016 meetings, the Task Force has continued its discussions related to the required understanding of internal control, and specifically related to the phrase “relevant to the audit.” Table 3 summarizes the requirements in ISA 315 (Revised) related to each component of internal control, as well as Task Force views on why the understanding is required and initial thoughts as to how those requirements are scalable.

Table 3. Components of Internal Control Relevant to the Audit (paragraph references in this table are to ISA 315 (Revised) unless otherwise stated)

Component of Internal Control	Auditor required to obtain an understanding of:	Why understanding of the component is required and initial thoughts on how the requirement to understand the component is scalable:¹⁵
<p>The control environment (paragraph 14)</p>	<ul style="list-style-type: none"> The control environment (seven elements of the control environment that may be relevant when obtaining an understanding of the control environment are set out in paragraph A77). 	<p>Paragraphs A76 and A80 to A83 provide considerations regarding the effect of the control environment on the assessment of the risks of material misstatement. Some of these are:</p> <ul style="list-style-type: none"> The control environment sets the tone of an organization, influencing the control consciousness of its people (from paragraph A76). Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement (from paragraph A80). An active and independent board of directors may influence the philosophy and operating style of senior management (from paragraph A81). The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement (from paragraph A82) The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement (paragraph A83). <p>The more complex the control environment, the more work will need to be performed to understand the elements of the control environment.</p> <p>In some small, less complex entities, this may require less work to obtain sufficient understanding to have identified risks of material misstatement as a result of the auditors understanding of the control environment.</p>

¹⁵ The views expressed in Table 3 regarding the scalability of the requirement to obtain an understanding of internal control are the Task Force's initial thoughts. The Task Force will continue to develop its views and recommendations regarding the scalability of the requirement to obtain an understanding of internal control, including the impact of the influence of a dominant owner-manager.

Component of Internal Control	Auditor required to obtain an understanding of:	Why understanding of the component is required and initial thoughts on how the requirement to understand the component is scalable: ¹⁵
<p>The entity's risk assessment process (paragraphs 15-17)</p>	<ul style="list-style-type: none"> • Whether the entity has such a process and, if so, to obtain an understanding of it, and the results thereof. If the entity does not have such a process or has an adhoc process, the auditor is required to evaluate whether the absence of a documented risk assessment process is appropriate in the circumstance, or determine whether it represents a significant deficiency in internal control. 	<p>The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement (from paragraph A87).</p> <p>In small, less complex entities there is unlikely to be an established risk assessment process and management will identify risks through personal involvement (such as a dominant owner manager) in the business. Inquiry, by the auditor, about the identified risks and how they are addressed is still necessary (from paragraph A88).</p>
<p>The information system, including relevant business processes (herein referred to as 'the information system'), relevant to financial reporting and communication (paragraphs 18-19)</p>	<ul style="list-style-type: none"> • The information system relevant to financial reporting; and • How the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting. 	<p>Obtaining an understanding of the information system and business processes is always important as the information system includes the accounting system (i.e., the procedures and records designed and established to, among other things, initiate, record, process and report entity transactions, events and conditions) (from paragraph A89).</p> <p>The information system in small, less complex entities (perhaps an 'off-the-shelf purchased information system compared to a more complicated Enterprise Resource Planning (ERP) system) are likely to be less sophisticated than in larger entities, but their role is just as significant. Understanding the entity's information system, in smaller entities, may be easier and more dependent on inquiry than on review of documentation when management is actively involved (from paragraph A93).</p> <p>Open communication between management, with those charged with governance and regulatory authorities assists to ensure that exceptions in financial reports are reported and acted on (from paragraph A94).</p>

Component of Internal Control	Auditor required to obtain an understanding of:	Why understanding of the component is required and initial thoughts on how the requirement to understand the component is scalable: ¹⁵
		<p>In small, less complex entities, communication may be less structured and easier to achieve due to greater management visibility and fewer levels of responsibility (from paragraph A95).</p>
<p>Control activities (paragraphs 20-21, 29 and 30)</p>	<ul style="list-style-type: none"> • Control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and [to] design further audit procedures that are responsive to the assessed risks (from paragraph 20) • For significant risks, the auditor is required to obtain an understanding of controls, including control activities, relevant to that risk (from paragraph 29). • For risks for which the auditor has judged that it is not possible or practicable to obtain sufficient appropriate evidence only from substantive procedures, the entity's controls over such risk is relevant to the audit and the auditor shall obtain an understanding of them (from paragraph 30). 	<p>Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities have various objectives and are applied at organizational and functional levels (from paragraph A96).</p> <p>The auditor's emphasis may be on identifying and understanding control activities that address the areas where risks of material misstatement are likely to be higher (from paragraph A99). The Task Force believes its recommendations related to the spectrum of inherent risk (paragraphs 30–37 of this paper) may be useful guidance for the auditor in determining the extent of control activities relevant to the audit.</p> <p>The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities (paragraph A100).</p> <p>Concepts underlying control activities in smaller entities would be similar to those in larger entities, but the formality with which they operate may vary. Small entities may find that certain types of control activities may not be relevant because of the controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong controls over important account balances and transactions, lessening the need for more detailed control activities (from paragraph A101).</p>

Component of Internal Control	Auditor required to obtain an understanding of:	Why understanding of the component is required and initial thoughts on how the requirement to understand the component is scalable: ¹⁵
Monitoring of controls (paragraphs 22-24)	<ul style="list-style-type: none"> • The major activities used to monitor internal control relevant to financial reporting. • The internal audit function, if there is one. • The sources of information used in the entity’s monitoring activities and why management considers them to be sufficiently reliable. 	<p>Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of control performance on a timely basis and taking remedial actions where necessary (from paragraph A106).</p> <p>In small, less complex entities, monitoring of controls is often accomplished by management’s close involvement in operations which will often identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control (from paragraph A108).</p> <p>If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor’s understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity’s monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor’s inquiries in paragraph 6(a) (inquiries of appropriate individuals within the internal audit function), may also provide information that is directly relevant to the auditor’s identification and assessment of the risks of material misstatement (paragraph A109).</p> <p>There is nothing for the auditor to understand about the internal audit function if such a function does not exist. However, similar to the auditor’s understanding of the entity’s risk assessment process, the auditor may judge it necessary to evaluate and document whether the absence of an internal audit function is appropriate in the circumstances.</p>

62. The Public Interest Oversight Board Observer (PIOB) at the September 2016 IAASB CAG meeting expressed a concern regarding the audits of financial institutions and the expectation that certain aspects of internal control should exist at these types of entities. The Task Force has considered this observation in its discussions and is of the view that this observation is best addressed by the IAASB's project related to special audit considerations relevant to financial institutions.

Matters for IAASB Consideration

10. Do IAASB members agree with the Task Force views related to the components of internal control in Table 3, including the initial thoughts related to scalability? IAASB members are asked to share their views as to why they do or do not agree.

Design and Implementation

63. Auditors of entities of all sizes have noted that the requirement to evaluate the design of controls and determine whether they have been implemented¹⁶ is not clear (i.e., regarding the objective of the requirement and the nature and extent of the work effort required in meeting the requirement) and how this can be effectively achieved for each of the components of internal control.
64. As part of this project, the IAASB agreed that the Task Force should explore revisions to ISA 315 (Revised) to clarify the differing nature and extent of work required by the auditor when:
- (a) Obtaining the required understanding of the components of internal control (in accordance with paragraph 12 of ISA 315 (Revised));
 - (b) Evaluating the design of those controls relevant to the audit and determining whether they have been implemented (in accordance with paragraph 13 of ISA 315 (Revised)); and
 - (c) Designing and performing tests of controls to obtain sufficient appropriate evidence as to the operating effectiveness of those controls relevant to the audit (in accordance with paragraph 8 of ISA 330).

The differentiation of the nature and extent of work required by the auditor in meeting the requirements referred to in 64(a) to 64(c) above is often more apparent with respect to controls within the control activities component of internal control, but not as apparent for controls within the other four components of internal control.

Task Force Views – Design and Implementation

65. The Task Force has had preliminary discussions regarding the challenges with design and implementation of controls and while the Task Force's discussions in this respect are still ongoing, the Task Force is interested in obtaining the IAASB's views on its thoughts to date. Through feedback received from the ISA Implementation Monitoring Project, Task Force member experiences and information gathered from outreach performed by the Task Force, the challenges regarding design and implementation of controls are viewed to be related to controls within the components of: the control environment; the entity's risk assessment process; information systems and communication; and monitoring of controls. With respect

¹⁶ ISA 315 (Revised), paragraph 13

to controls within the control activities component, challenges are generally related to which of those controls are relevant to the audit, and less with the design and implementation of those controls.

66. For design and implementation of controls within the control environment, the entity’s risk assessment process, information systems and communication and monitoring of controls, the Task Force is of the view that the requirements within the relevant paragraphs in ISA 315 (Revised) (being paragraphs 14–19 and 22–24, and the related application material) already provide the requirements that the auditor needs to meet in order to evaluate the design of controls within those components and determine whether they have been implemented in accordance with paragraph 13 of ISA 315 (Revised).
67. Similar to the Task Force’ views related to the challenges with paragraph 12 of ISA 315 (Revised), the Task Force is of the view that creating a clearer link between the requirement in paragraph 13 of ISA 315 (Revised) and the requirements in paragraphs 14–19 and 22–24 (and related application material) in ISA 315 (Revised) would clarify for auditors how the requirement in paragraph 13 of the standard is met. In addition, the Task Force intends to analyze the application material in extant ISA 315 (Revised) related to paragraphs 14–24 of the standard and determine how the existing guidance applies to obtaining an understanding of the component (and the respective controls within it) or evaluating the design of those controls and whether they have been implemented, and assess whether additional guidance is needed to address any gaps. Refer to Table 4 for further discussion on the Task Force’s exploration of this area.

Table 4. Nature and Extent of the Understanding
<p>ISA 315 (Revised) – Extant</p> <p>13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity’s personnel. (Ref: Para. A73–A75)</p>
<p>Task Force Recommendations</p> <p>Without yet making suggestions for possible wording changes to, or the development of guidance related to the application of, paragraph 13 of ISA 315 (Revised), the Task Force recommends possible revisions to be made to:</p> <ul style="list-style-type: none"> • Create a link between the overarching requirement in paragraph 13 of ISA 315 (Revised) for the auditor to evaluate the design of the controls relevant to the audit and determine whether they have been implemented and the requirements in paragraphs 14–24 of ISA 315 (Revised) which include requirements and related application material that help the auditor determine how to meet paragraph 13 of the standard; • In addition to the analysis referenced in paragraph 67 of this paper, clarify that testing the operating effectiveness of controls is different from obtaining an understanding of the control, evaluating the design of the control and determining if the control has been implemented; and • Clarify that the requirement related to the design and implementation of controls is only in respect of controls relevant to the audit.

Matters for IAASB Consideration

11. Do IAASB members agree with the Task Force recommendations to:
- (a) Propose revisions to paragraph 13 of ISA 315 (Revised) to make it clearer that the auditor should be assessing design and implementation of controls for only those controls that are relevant to the audit and creating a link between the overarching requirement in paragraph 13 of ISA 315 (Revised) and the requirements in paragraph 14–24 of the standard?
 - (b) Analyze the application material related to paragraphs 14–24 in ISA 315 (Revised) to determine how the existing guidance applies to obtaining an understanding of the component (and the respective controls within it) or evaluating the design of the those controls and determining whether they have been implemented, and assess whether additional guidance is needed to address any gaps?

VI. Other Matters Discussed by the Task Force

Link to Acceptance and Continuance of Audit Engagements

68. The Task Force discussed the need to respond to feedback received in response to the December 2015 Invitation to Comment, *Enhancing Audit Quality in the Public Interest—A Focus on Professional Skepticism, Quality Control and Group Audits*, which referred to the need to strengthen the link between ISA 220¹⁷ related to identifying and assessing quality risks and putting in place the appropriate responses to address those risks and the identification of risks arising from the client continuance and acceptance procedures.

Task Force Views – Information Obtained in the Acceptance or Continuance Process

69. The Task Force discussed the requirement in paragraph 7 of ISA 315 (Revised) regarding the auditor's consideration of information obtained from the auditor's client acceptance or continuance process in identifying risks of material misstatement. The Task Force was of the view that the requirement should be made stronger, as:
- (a) Information gathered during the client acceptance and continuance process would be expected to include information about risks that are relevant to the auditor's risk assessment, and therefore should be considered by the auditor; and
 - (b) There is inconsistency in practice in using information obtained during the client acceptance or continuance process in the identification of risks of material misstatement.

Task Force Recommendations

70. The Task Force recommends the following revision to paragraph 7 of ISA 315 (Revised):
- In identifying risks of material misstatement, the auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.

¹⁷ ISA 220, *Quality Control for an Audit of Financial Statements*

71. The Task Force recommends the development of application material to explain why information that is obtained during the acceptance or continuance process is relevant to the identification of risks of material misstatement.
72. The Task Force will coordinate with the ISA 220 (Crossover) Working Group in further considering changes to this aspect.

Matter for IAASB Consideration

12. Do IAASB members agree with the proposed revision to paragraph 7 of ISA 315 (Revised) and the recommended application material? IAASB members are asked to share their views as to why they do or do not agree.

VII. Way Forward

73. The Task Force will take into account the feedback that it receives on the issues and recommendations discussed in this paper to further progress the revisions to ISA 315 (Revised).
74. The Task Force has a meeting planned the week after the IAASB's December 2016 meeting where the following will be discussed (in addition to the feedback that is received in relation to the IAASB's December 2016 meeting):
 - (a) Matters related to IT, such as:
 - (i) When are IT general controls relevant to the audit, particularly in the context of the environment of complex IT and financial reporting systems, electronic audit evidence etc.
 - (ii) The relationship between IT general controls and application controls (IT dependent control activities).
 - (iii) The nature and extent of the work effort related to design and implementation of general IT controls required, including when performing a primarily substantive audit.
 - (iv) The extent of the auditor's consideration of IT in assessing whether there are risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.
 - (b) With input from the DAWG,¹⁸ how data analytics is able to support the auditor's obtaining an understanding of the entity and its environment and obtaining an understanding of internal control, including initial discussions on how data analytics could best be incorporated into ISA 315 (Revised).
 - (c) With input from the Professional Skepticism Working Group, initial considerations on how to emphasize the importance of the application of professional skepticism and professional judgment at the risk assessment stage of the audit.
75. With respect to ISA 315 (Revised) and its interaction with other internal control frameworks, the Task Force has received clear direction from the IAASB at its June 2016 meeting that the standard should

¹⁸ The DAWG will be providing the Task Force with a detailed briefing paper in advance of the Task Force's December 2016 meeting. This detailed briefing paper will include DAWG views and recommendations for the Task Force's consideration related to how data analytics can support the auditor's risk assessment procedures and provide a basis for further discussions between the Task Force and the DAWG.

remain framework neutral. The Task Force is currently of the view that the components of internal control in extant ISA 315 (Revised) are appropriate and the Task Force does not intend to make any changes to the components of internal control. The Task Force is planning, once it has clearer direction on the IAASB's views on issues related to internal control relevant to the audit, including IT, to evaluate whether enhancements and revisions to other internal control frameworks (such as COSO's¹⁹ Internal Control-Integrated Framework (2013)) that have occurred since ISA 315 (Revised) was first issued should be incorporated into the standard.

¹⁹ Committee of Sponsoring Organizations of the Treadway Commission

Extracts of relevant PCAOB references noted throughout the paper

PCAOB AS 12

Identifying and Assessing the Risks of Material Misstatement

59. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should:

...

- e. Identify significant accounts and disclosures³³ and their relevant assertions³⁴ (paragraphs 60–64 of this standard).

Note: The determination of whether an account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

...

³³ Paragraph A10 of Auditing Standard No. 5 states:

“An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.”

³⁴ Paragraph A9 of Auditing Standard No. 5 states:

“A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.”

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

60. To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 59.e., the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account and disclosure characteristics.”

Extracts of relevant ISA references noted throughout the paper

ISA 315 (Revised)

28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
- (a) Whether the risk is a risk of fraud;
 - (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
 - (c) The complexity of transactions;
 - (d) Whether the risk involves significant transactions with related parties;
 - (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
 - (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A132–A136)

Draft summary of the IAASB's discussions at its September 2016 meeting²⁰

ISA 315 (Revised)

PROJECT PROPOSAL

Ms. Campbell provided the Board with an overview of **Agenda Item 3-A**, the draft ISA 315 (Revised) project proposal (the draft project proposal). Ms. Campbell noted that, as part of the due process, the draft project proposal had been circulated to other committees of the International Federation of Accountants (IFAC) as well as the other standard setting boards (i.e., the International Ethics Standards Board for Accountants (IESBA), the International Accounting Education Standards Board (IAESB) and the International Public Sector Accounting Standards Board), and that no further comments for changes to the draft project proposal were received.

Ms. Campbell noted that CAG Representatives and Observers had provided comments on the draft project proposal at its meeting the previous week, noting support for the project and that further consideration should be given to:

- The auditor's consideration of technology in gaining the required understanding of the entity's information system;
- Simplification, where possible, of the language used in ISA 315 (Revised) and the development of visual aids to make use of the standard more effective;
- Including ISA 260 (Revised)²¹ in the scope of the project;
- Requiring the auditor to obtain an understanding of the entity's business model when obtaining an understanding of the entity; and
- In relation to audits of public sector entities, whether related guidance could direct auditors to assessing fiscal sustainability as part of the risk assessment process.

Ms. Campbell also highlighted that the Small and Medium Practices (SMP) Committee noted support for the draft project proposal and acknowledged the interactions between the ISA 315 (Revised) Working Group and the SMP Committee to date, emphasizing the importance of the interactions as the project progresses.

The IAASB was supportive of the draft project proposal and in addition to various editorial suggestions, suggested the ISA 315 (Revised) Working Group add the following to the project proposal:

- Additional specificity regarding the interactions between ISA 315 (Revised) and ISA 330, specifically paragraph 18 of ISA 330, but without suggesting that this project will include a full revision of ISA 330;
- Enhanced linkage to the data analytics project, including that further consideration of the impact of data analytics to the project to revise ISA 315 (Revised) will be given based on the feedback

²⁰ These draft minutes are still subject to IAASB review and may be subject to further change.

²¹ ISA 260 (Revised), *Communication with Those Charged with Governance*

received from the Data Analytics Working Group's Request for Input: [Exploring the Growing Use of Technology in the Audit, with a Focus on Data Analytics](#);

- More closely aligning the auditor's risk assessment with the objective of the auditor in ISA 200²² (i.e., reducing audit risk to an acceptably low level); and
- The effect of long association of an auditor with an entity on the auditor's risk assessment.

Prof. Schilder noted that, notwithstanding the expectations to complete this project quickly, the timeline set out a reasonable time to work through the revision of the standard in a robust way. The IAASB agreed with the timeline as set out in the draft project proposal.

IAASB CAG CHAIRMAN'S REMARKS

Mr. Waldron noted that the CAG Representatives and Observers were supportive of the project proposal to revise ISA 315 (Revised) and that Ms. Campbell had summarized their input on the project proposal accurately.

APPROVAL OF THE PROJECT PROPOSAL

After agreeing how the IAASB's comments would be addressed, the IAASB unanimously approved the project proposal to revise ISA 315 (Revised) with 18 affirmative votes out of the 18 IAASB members present.

ISSUES AND RECOMMENDATIONS

Ms. Campbell explained that three issues had been prioritized for discussion with the IAASB to be able to respond to concerns relating to ISA 540 as work on developing changes to that standard progresses. Ms. Campbell provided an overview of **Agenda Item 3-B**, focusing the IAASB's attention on the matters where specific input was being requested related to the components of internal control relevant to the audit, significant risks and the proposal related to a spectrum of risk.

Ms. Campbell summarized the feedback received at the CAG meeting, noting that the Representatives and Observers:

- Agreed that obtaining an understanding of internal control informs the auditor's assessment of inherent risk, in addition to the auditor's assessment of control risk, and also supported efforts to clarify the purpose of the auditor obtaining an understanding of internal control;
- Cautioned that the lines between inherent risk and control risk should not be blurred, as these are concepts have been in place for a long time and are well-understood;
- Commented that, in audits of small- and medium-sized entities (SMEs), the assessments of inherent risk and control risk are often performed on a combined basis due to the challenges of distinguishing between inherent risk and control risk in an SME audit, and that further guidance would be helpful;
- Noted that the effect of a dominant owner-manager should be recognized in ISA 315 (Revised), with further consideration of the potential impact on inherent risk and control risk;

²² ISA 200, *Overall Objectives of The Independent Auditor and The Conduct of An Audit In Accordance with International Standards on Auditing*, paragraph 13(l)

- Noted the auditor is required to understand internal control sufficient to assess risks of material misstatement and plan the audit. Understanding of internal control is an area of judgment for the auditor and the requirement to understand internal control should be scalable in itself, as a less complex entity will have less to understand about internal control when compared with a more complex entity;
- Queried whether the basis for the components of internal control in ISA 315 (Revised) would be based on the five components in COSO's²³ Internal Control-Integrated Framework (2013) (COSO Framework);
- Agreed with the ISA 315 (Revised) Working Group's recommendation to retain the concept of significant risk, regardless of whether the standard continues to refer to the highest risks of material misstatement as "significant risks" or whether it is referred to utilizing some other term;
- Agreed with the ISA 315 (Revised) Working Group's observation that the definition of significant risk is circular and therefore that the definition should be revisited;
- Were supportive of the ISA 315 (Revised) Task Force exploring the explicit introduction of the concept of a spectrum of risk in ISA 315 (Revised). However, Representatives and Observers cautioned against introducing more complexity into the standard, as a spectrum of risk has the potential to do that (especially if a certain number of categories of risk were introduced).

Ms. Campbell also noted that the SMP Committee had also provided feedback on the matters set out in **Agenda Item 3-B**.

Components of Internal Control Relevant to the Audit

The Board expressed support for the ISA 315 (Revised) Task Force continuing to explore how the requirements to understand internal control can be made more scalable, including providing clarity about the purpose for the auditor obtaining an understanding of internal control.

The Board agreed that the existing audit risk model is still appropriate and should be retained. The Board disagreed with the view that an additional purpose of obtaining an understanding of internal control informs the auditor's assessment of inherent risk, as well as the auditor's assessment of control risk. Board members noted that stating that obtaining an understanding of controls informed inherent risk would create confusion without really assisting auditors with the identification of risks of material misstatement. More specifically, Board members variously noted that:

- The purpose of obtaining an understanding of internal control is already well set out in paragraph 20 of ISA 315 (Revised), and suggested making it clearer that the auditor may be able to learn more about the inherent risk from what and how the entity has attempted to control those inherent risks;
- The significant challenges that need to be addressed within this area are (a) the implicit reliance on controls (i.e., reliance on controls by the auditor without appropriate evaluation of those controls), more specifically higher-level controls, by some SMPs and auditors of SMEs and (b) the fact that auditors that have determined to take a primarily substantive approach to the audit do not see the value of obtaining an understanding of internal control, and therefore view the requirement

²³ Committee of Sponsoring Organizations of the Treadway Commission

in ISA 315 (Revised) to obtain an understanding of internal control as unnecessary and as a compliance exercise.

- It is important for there to be a clear link between the overarching requirement to understand internal control in paragraph 12 of ISA 315 (Revised), and the requirements related to understanding each of the individual components of internal control (paragraphs 14–24).
- The five components of internal control are interlinked and therefore were generally not supportive of suggesting that some of the components are always relevant to an audit, while other components may not always be relevant to the audit.
- The components of internal control should be kept “wrapped” together, to make it clear in ISA 315 (Revised) that in an audit of an SME, the auditor could obtain an understanding of internal control relatively quickly whereas in a larger entity the auditor would need to do more to obtain the appropriate understanding.

Significant Risks

In the discussions related to significant risks, the Board generally agreed that the:

- Concept of significant risk in ISA 315 (Revised) should be retained (i.e., continue to be a subset of the population of inherent risks).
- Definition of significant risk is circular and that the ISA 315 (Revised) Task Force should explore revising the definition with a focus on the nature of the risk.
- The proposed factors for the auditor to consider in the identification of inherent risk of complexity, ambiguity, change and uncertainty were appropriate, with one Board member adding that the ISA 315 (Revised) Task Force should also consider whether the source of data and management bias be added to those factors. With respect to assessing inherent risk in the context of their likelihood and magnitude, one Board member expressed that magnitude should be the primary factor considered by the auditor and that likelihood be a secondary factor.

With regard to the use of ‘two filters’ in the identification of significant risks, the Board was supportive of the ISA 315 (Revised) Task Force continuing to explore this line of thinking, however the Board noted the need to more clearly understand how the proposal would work in practice. The Board specifically noted that clarity is needed about how the use of the proposed filters would interact with the proposed factors for evaluating the relative severity of an identified risk of material misstatement. In addition, the ISA 315 (Revised) Task Force should be clearer about whether it is proposing that identification of significant risk should also take control risk into consideration.

Spectrum of Risks

The Board was supportive of the ISA 315 (Revised) Task Force continuing to explore the explicit inclusion in ISA 315 (Revised) of a spectrum of risk, cautioning the ISA 315 (Revised) Task Force of the possible consequence that this may introduce unnecessary additional complexity. One Board member questioned whether the explicit reference to a spectrum of risk would achieve anything in ISA 315 (Revised) as the response for the work effort is required under ISA 330. In response, the view was expressed that having a more explicit acknowledgment of the spectrum of risk in ISA 315 (Revised) would practically assist auditors in tailoring responses under ISA 330. In addition, it was noted that this may also address the observation that

too much of the auditor's resources are focused on responding to significant risks at the expense of those 'other' risks of material misstatement that are not identified as significant risk but still require the auditor's attention.

WAY FORWARD

The ISA 315 (Revised) Task Force will continue to progress the changes to ISA 315 (Revised), taking into account the CAG and Board's feedback. The ISA 315 (Revised) Task Force will bring further matters for discussion to the December 2016 meeting on issues identified in the project proposal.