

**Initial Discussion on the IAASB's Future Project Related to
ISA 315 (Revised)¹****Objectives of the IAASB Discussion**

The objective of this agenda item are to:

- (a) Present initial background from various sources about issues and concerns relating to ISA 315 (Revised).
- (b) Obtain views from the Board on the matters addressed herein to inform the ISA 315 (Revised) Working Group (WG) as it commences activities.

I. Background

1. ISA 315 (Revised) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.²
2. While there have been no substantive changes to ISA 315 since its issuance in 2003, changes have arisen as a result of:
 - The IAASB's ISA 610³ project, which resulted in limited amendments.⁴
 - The IAASB's Disclosures project, described further in paragraphs 18–21 of this paper.
3. ISA 315 (Revised) states⁵ that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

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

² ISA 315 (Revised), paragraph 1

³ ISA 610 (Revised 2013), *Using the Work of Internal Audit*

⁴ The IAASB's objective in revising ISA 315 and ISA 610 was to enhance the performance of external auditors by, (a) enabling them to better consider and leverage, as appropriate, the knowledge and findings of an entity's internal audit function in making risk assessments in the external audit, and (b) strengthening the framework for the evaluation and, where appropriate, use of the work of internal auditors in obtaining audit evidence. The amendments to ISA 315 resulting from the ISA 610 project were primarily a) to require the external auditor to make inquiries of appropriate individuals within the internal audit function (if the function exists) as part of the external auditor's Risk Assessment Procedures and Related Activities and b) clarify the linkage between ISA 315 and ISA 610.

⁵ ISA 315 (Revised), paragraph 3

4. The IAASB's [Work Plan for 2015-2016](#) (the Work Plan) discusses the preliminary approach to a project in relation to ISA 315 (Revised) as a Staff-led initiative to gather information about:
 - The potential objectives and scope of a possible project to address the issues that have been identified by the ISA Implementation Monitoring project.⁶
 - Possible changes that may be necessary to ISA 315 (Revised) to enhance the requirements and guidance for evolving environmental influences (such as changing internal control frameworks⁷ and more advanced technology systems being utilized by both management and auditors).

The Work Plan noted that, in particular, coordination with firms and regulators will be necessary to inform the IAASB as to an appropriate way forward, which could include specific enhancements to ISA 315 (Revised), additional guidance or a more fundamental consideration of the implications for the auditor's risk assessment and response.

5. In the course of the disclosures project, issues were identified related to ISA 315 (Revised), in particular in relation to paragraph 12 and paragraph 18, which address requirements for the auditor to understand internal control relevant to the audit and the information systems, respectively.
6. Amendments, if any, to ISA 315 (Revised) arising from this project may also result in the need for amendments to ISA 330.⁸
7. Matters for IAASB consideration are presented on page 17 of this paper.

II. Post-Implementation Review Findings Related to ISA 315 (Revised)

8. The [findings from the post-implementation review](#) were published in July 2013. Key and important themes⁹ specifically related to ISA 315 (Revised), including the requirements and related application material in ISA 315 (Revised), are included in the table below.

⁶ The IAASB's ISA Implementation Monitoring project was a post-implementation review of the ISAs clarified and revised in the IAASB's Clarity project, and was completed in July 2013. The primary objective of the post-implementation review was to determine what, if any, changes are needed in order to increase the consistency of practitioners' understanding of the ISAs; and, whether the IAASB achieved its goals in revising them. The post-implementation review was targeted at those stakeholders most directly involved in the audit process (audit inspection bodies and other regulators, auditors (both in the public and private sector), and national auditing standard setters (NSS)), in jurisdictions that had implemented the clarified ISAs in line with the effective date set by the IAASB (i.e., for periods beginning on or after December 15, 2009)

⁷ For example, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework "Internal Control—Integrated Framework (2013)"

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

⁹ Issues identified were classified as "key" when there was a body of evidence to suggest that the ISA was not being consistently understood and applied in a manner that achieved the IAASB's goals in revising it. In addition, changes to that ISA would also likely have the greatest potential for improving audit quality. Themes were classified as "important" when there was some evidence that the ISA was not being consistently understood and applied in a manner that achieved the IAASB's goals in revising it.

9. Inconsistency in the nature and number of significant risks identified (Key Theme)	
Post-Implementation Review Finding	There appears to be inconsistency in the number of significant risks being identified in practice. This has a consequential effect on the work effort to respond to these risks. Some believe the definition of significant risk is not clear. Some view it as circular because it focuses on the implications of the risk (i.e., “requires special audit considerations”) rather than the nature of the risk itself.
Relevant ISA 315 (Revised) References	<p>Definitions</p> <p>Significant risk – An identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration.</p> <p>Requirements</p> <p><i>Risks that Require Special Audit Consideration</i></p> <p>27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor’s judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.</p> <p>28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:</p> <ul style="list-style-type: none"> (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) <p>29. If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity’s controls, including control activities, relevant to that risk. (Ref: Para. A137–A139)</p> <p>Application Material</p> <p><i>Significant Risks</i></p> <p>Identifying Significant Risks (Ref: Para. 28)</p> <p>A132. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant</p>

	<p>measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.</p> <p>A133. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:</p> <ul style="list-style-type: none">• Greater management intervention to specify the accounting treatment.• Greater manual intervention for data collection and processing.• Complex calculations or accounting principles.• The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks. <p>A134. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:</p> <ul style="list-style-type: none">• Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.• Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value. <p>A135. ISA 330 describes the consequences for further audit procedures of identifying a risk as significant.¹⁰</p> <p>Significant risks relating to the risks of material misstatement due to fraud</p> <p>A136. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.¹¹</p> <p>Understanding Controls Related to Significant Risks (Ref: Para. 29)</p> <p>A137. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:</p> <ul style="list-style-type: none">• Control activities such as a review of assumptions by senior management or experts.• Documented processes for estimations.• Approval by those charged with governance. <p>A138. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and</p>
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¹⁰ ISA 330, *The Auditors Responses to Assessed Risks*, paragraphs 15 and 21

¹¹ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 25–27

	<p>how it is proposed that the circumstances are to be disclosed in the financial statements.</p> <p>A139. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.¹²</p>
Interaction with other current IAASB projects	<p>ISA 600¹³</p> <p>Issues have been noted relating to risks that have been identified at the component level but not appropriately considered at the group level, and the work effort related to identified significant risks across the group (see paragraphs 32–36 of this paper).</p> <p>ISA 540¹⁴</p> <p>The definition and identification of significant risks and the relationship with high estimation uncertainty is also important to the IAASB's work to revise ISA 540 (see paragraph 28 of this paper).</p>
10. Identification of Controls Relevant to the Audit (Key Theme)	
Post-Implementation Review Finding	<p>Respondents noted that the requirements to obtain an understanding of internal control¹⁵ and control activities¹⁶ “relevant to the audit” can be difficult to apply in practice. It was noted that the guidance on identifying controls that are relevant to the audit is not clear and in some cases controls that are identified for testing do not address the identified risks of material misstatement. A number of respondents thought that the requirements in ISA 315 (Revised) are excessive if, as is the case on many smaller audits, a substantive approach to testing is adopted.</p>
Relevant ISA 315 (Revised) References	<p>Requirements</p> <p><i>The Entity's Internal Control</i></p> <p>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. A49–A72)</p> <p>Nature and Extent of the Understanding of Relevant Controls</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</p>

¹² ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A7

¹³ ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

¹⁴ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

¹⁵ Paragraph 12 of ISA 315 (Revised) requires the auditor to obtain an understanding of internal control relevant to the audit.

¹⁶ Paragraph 20 of ISA 315 (Revised) requires the auditor to obtain an understanding of control activities relevant to the audit...in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks.

	<p>been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A73–A75)</p> <p>Control activities relevant to the audit</p> <p>20. The auditor shall obtain an understanding of 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 design further audit procedures responsive to assessed risks. 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. (Ref: Para. A96–A102)</p> <p>Application Material</p> <p>The Entity's Internal Control (Ref: Para. 12)</p> <p>A49. 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.</p> <p>A50. The following application material on internal control is presented in four sections, as follows:</p> <ul style="list-style-type: none"> • General Nature and Characteristics of Internal Control. (Para. A51–A66) • Controls Relevant to the Audit. (Para. A67–A72) • Nature and Extent of the Understanding of Relevant Controls. (Para. A73–A75) • Components of Internal Control. (Para. A76–A102) <p>ISA 315 (Revised) paragraphs A51–A102 not shown in this paper – refer to ISA 315 (Revised) in Agenda Item 3-B for these paragraphs.</p>
11. Risks and Controls Arising from IT (Important Theme)	
<p>Post-Implementation Review Finding</p>	<p>Some suggest that ISA 315 (Revised) is not sufficiently reflective of the complexity of the information systems used by many larger entities and the central importance of these systems to the audit of the financial statements. Some believe that, because information technology (IT) risks are not emphasized sufficiently in ISA 315 (Revised), general IT controls may not be tested sufficiently when reliance is placed on IT-dependent controls.</p>
<p>Relevant ISA 315 (Revised) References</p>	<p>Requirements</p> <p>21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A103–A105)</p> <p>Application Material</p> <p>Risks Arising from IT (Ref: Para. 21)</p> <p>A103. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the</p>

	<p>integrity of information and the security of the data such systems process, and include effective general IT controls and application controls.</p> <p>A104. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:</p> <ul style="list-style-type: none">• Data center and network operations.• System software acquisition, change and maintenance.• Program change.• Access security.• Application system acquisition, development, and maintenance. <p>They are generally implemented to deal with the risks referred to in paragraph A63.</p> <p>A105. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.</p>
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12. Other themes (i.e., that were not classified as key or important) arising from the post-implementation review related to ISA 315 (Revised) included:

A. Practical Issues Relating to Risk Assessment

Some respondents identified practical issues relating to assessing risk at the assertion level, specifically that there is insufficient practical guidance on assessing risks of material misstatement at the financial statement and assertion level to achieve the stated objective of ISA 315 (Revised). These respondents suggested that consideration be given to additional application material explaining the risk assessment process.

B. Documentation of Risk Assessment Procedures

A few respondents have the view that more guidance is needed regarding the nature and extent of documentation for understanding the business and especially internal controls, in particular for the audits of Small and Medium Entities (SMEs).

C. Organization of the Standard

A few respondents have the view that the organization of the standard is very complex, such that the requirements and guidance are difficult to implement in a work flow or logical sequence of risk assessment procedures.

III. Other Issues Related to ISA 315 (Revised)

Audits of SMEs

13. Several of the matters noted in the ISA post-implementation monitoring project related to challenges experienced by those who perform audits of SMEs. Often, SMEs engage in relatively simple business transactions, which means that their audits under the ISAs will generally be relatively straightforward.
14. The ISAs, including ISA 315 (Revised), include considerations specific to smaller entities, which are intended to assist in the applications of the requirements of the ISAs in the audits of such entities.¹⁷ The ISAs specifically anticipate their application to an audit of an SME. For example, in relation to requirements within various ISAs:
 - They specify alternative procedures regarding understanding the entity's risk assessment process when the entity has not established such a process or it has an ad hoc process (a common occurrence in SMEs).¹⁸
 - They specify a choice of audit procedures based on the particular circumstances (e.g., choice of responses to assessed risks for accounting estimates under ISA 540¹⁹ where the option of using evidence arising from events occurring after the date of the financial statements is often an effective response in an SME audit, when such evidence is relevant to the accounting estimate and there is a long period between the date of the statement of financial position and the date of the auditor's report).
 - They indicate if a requirement is conditional, for example, where those charged with governance and management are the same (a situation often seen in SMEs).²⁰
15. In addition, the application and other explanatory material in ISA 315 (Revised) contains a number of considerations specific to the audit of smaller entities.²¹
16. However many auditors have noted challenges with the application of the ISAs to audits of SMEs. This feedback and other initiatives, such as the Nordic Federation of Accountants' proposals to develop a standard for audits of smaller entities,²² suggests that it may not be sufficiently clear how the ISAs' risk-based approach can be appropriately applied to SMEs.

¹⁷ These additional considerations do not, however, limit or reduce the responsibility of the auditor to comply with the requirements of the ISAs. The 2009 IAASB Staff publication [Staff Questions & Answers - Applying ISAs Proportionately with the Size and Complexity of an Entity](#) further highlights how the design of the ISAs enables them to be applied in a manner proportionate with the size and complexity of an entity.

¹⁸ ISA 315 (Revised), paragraph 17

¹⁹ ISA 540, paragraph 13

²⁰ ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

²¹ ISA 315 (Revised), paragraphs A17, A23, A48, A52, A56–A57, A84–A86, A88, A93, A95, A101–A102 and A108

²² The [IAASB has responded](#) to the [Nordic Federation of Accountants'](#) initiative to explore ways to further support small and medium practices promote audits as a valued service for SMEs.

Additional Feedback from Practice

17. In addition to the matters noted in the ISA post-implementation review, questions that arise in practice relevant to ISA 315 (Revised) include:
- At what level should the risk assessment be done? At the financial statement level or at a level lower than the financial statements?
 - Whether there is an over emphasis in the auditor's response to assessed risks on those risks that have been identified as significant risks, and whether significant risks receive a disproportionate level of the auditor's work effort in relation to the level of effort dedicated to non-significant risk areas?
 - Should the number of significant risks increase relevant to the increase in size and complexity of the entity?
 - Should the complexity of the entity's information system be more of a consideration in the auditor's assessment of the risks of material misstatement?

IV. Interactions with Other IAASB Projects

Interaction with Completed Projects

Addressing Disclosures in the Audit of Financial Statements

18. In July 2015, the IAASB released [*Addressing Disclosures in the Audit of Financial Statements – Revised ISAs and Related Conforming Amendments*](#) (effective for audits of financial statements for periods ending on or after December 15, 2016). The objective of the disclosures project was to focus auditors on addressing disclosures throughout the audit process by:
- Enhancing the requirements in various ISAs to drive changes in the auditor's approach and improve consistency in practice to more specifically address disclosures, in particular qualitative disclosures.
 - Clarifying the auditor's work effort in relation to disclosures by providing additional guidance to assist auditors in better applying the requirements relating to disclosures.
19. Disclosures are an integral part of the financial statements and therefore addressing disclosures is an integral part of the audit of financial statements. It is therefore important that during all stages of the audit, including when obtaining an understanding of the entity, its environment and the entity's internal control, the auditor gives appropriate consideration to, and includes work effort on, disclosures.
20. As part of the disclosure project, consideration was given to changes in ISA 315 (Revised) relating to the understanding of the entity and its environment, including internal controls. Below is a summary of the relevant changes to the requirements and application material in ISA 315 (Revised 2015)²³ arising from this project:
- (a) *Paragraph 18 and related application material:* The changes clarify that, when obtaining an understanding of the entity and its environment, including internal controls, the understanding of the information system also includes the aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers.

²³ ISA 315 (Revised) updated for amendments arising from the disclosures project

The change in the requirement and the related application material emphasizes that certain of the information in disclosures may originate from outside the general and subsidiary ledgers, and was made to focus auditors on this aspect of the information system.

In making these amendments, the IAASB was mindful to not inadvertently “scope into the requirement” the need to obtain a more comprehensive understanding of systems and processes that may not be relevant to the audit, thereby increasing the auditor’s work effort unnecessarily. Accordingly, the IAASB agreed to highlight in the application material²⁴ that it is only the relevant aspects of the information systems that were applicable to this understanding, and that the extent of the understanding is matter of the auditor’s professional judgment. The IAASB also provided revised and clarified examples of what these other sources of information could be to provide guidance to the enhanced requirement.²⁵

(b) Other changes to ISA 315 (Revised 2015) arising from the disclosures project included:

- *Integrating the assertions* for presentation and disclosure in ISA 315 (Revised 2015) with the assertions for account balances, classes of transactions and events to encourage addressing related disclosures with audit procedures for these elements. The changes also address the assertions for disclosures not directly related to account balances, classes of transactions and events.
- Highlighting considerations around qualitative disclosures when identifying and assessing the risks of material misstatement.
- *Focusing the auditor’s attention on disclosures earlier in the audit process*, such as during the engagement team discussion. Additional matters relating to disclosures were added, such as discussions about complex matters relating to disclosures, including those involving significant judgment as to what information to disclose.²⁶
- Making certain changes to address some of the concerns raised about qualitative disclosures. This included making specific reference made to qualitative disclosures in paragraph 26(a) and removing the reference to “magnitude” in paragraph 26(d) to emphasize that misstatements could arise in amounts or in narrative disclosures.

21. While these changes to ISA 315 (Revised 2015) from the disclosure project are not yet effective, the intent is to strengthen the auditor’s risk assessment process as it relates to disclosures. Details of the changes to ISA 315 (Revised 2015) arising from the disclosures project can be found in **Agenda Item 3-C**.

²⁴ ISA 315 (Revised 2015), paragraph A89b (see **Agenda Item 3-C**)

²⁵ ISA 315 (Revised 2015), paragraph A89a (see **Agenda Item 3-C**)

²⁶ ISA 315 (Revised 2015), paragraph A21a (see **Agenda Item 3-C**)

New and Revised Auditor Reporting Standards

22. The new and revised Auditor Reporting standards, issued in January 2015 and effective for audits of financial statements for periods ending on or after December 15, 2016, introduced key enhancements that interact with ISA 315 (Revised), including:
- A new section, required in auditors' reports of listed entities²⁷, to communicate key audit matters (KAM). KAM are those matters that, in the auditor's judgment, were of most significance in the audit of the current-period financial statements (see below for interaction with ISA 315 (Revised)).
 - An enhanced description of the responsibilities of the auditor which is more closely aligned with the requirements of ISA 315 (Revised).

Determining KAM

23. To determine KAM, ISA 701²⁸ sets out a decision framework for auditors, using the communications with those charged with governance as a starting point. From the matters communicated with those charged with governance, the auditor determines those matters that required significant auditor attention. In fulfilling this requirement, the auditor is always required to explicitly consider:
- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).
 - (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
 - (c) The effect on the audit of significant events or transactions that occurred during the period.

From these matters, the auditor determines which were of the most significance in the audit of the financial statements of the current period and therefore are the KAM.²⁹

24. No conforming amendments were made to ISA 315 (Revised) as a result of the auditor reporting project, although ISA 701 does provide additional guidance to assist in the consideration of KAM and stress the link to the auditor's risk assessment and response. There may therefore be implications for the new and revised Auditor Reporting standards to the extent amendments, if any, are made to ISA 315 (Revised) that impact the matters noted above.

Enhanced Description of Auditor Responsibilities

25. ISA 700 (Revised)³⁰ requires an improved description of the responsibilities of the auditor and key features of an audit in the auditor's report (together with the provision for certain components of this description to be relocated to an appendix to the auditor's report, or for reference to be made to such description on the website of an appropriate authority). These changes are intended to align with the

²⁷ Law or regulation may also require the auditor to communicate KAM and the auditor may also do so voluntarily (when not a listed entity or required by law or regulation).

²⁸ ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraph 9

²⁹ ISA 701, paragraph 10

³⁰ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 39–40

risk-based approach of ISA 315 (Revised). An illustration of the required description is included in the Appendix to this paper.

Interaction with Current IAASB Projects

26. Recognizing the interactions between various IAASB projects and the importance of coordination among various working groups, there will be a joint meeting of the ISA 540 Task Force, Professional Skepticism, Data Analytics and ISA 315 (Revised) WGs as part the March 2016 IAASB meeting. The purpose of the joint meeting is to take the opportunity for these groups to reflect on the IAASB's and the IAASB Consultative Advisory Group's discussions at their respective March 2016 meetings on the individual topics. The joint meeting of these working groups and task force will allow the IAASB to continue to assess and evaluate the implications of the interactions between the various projects.

Professional Skepticism

27. Professional skepticism is essential in all aspects of the audit, including in the planning and risk assessment stage. The activities of the Professional Skepticism Working Group (PSWG) will be exploring what can be done to re-emphasize the important role of professional skepticism in audits of financial statements. In relation to the ISAs, the IAASB's Invitation to Comment (ITC)³¹ notes that further consideration will be given to whether the current requirements and guidance in the ISAs that refer to professional skepticism are clear as to what is expected from auditors, including:
- Whether the manner in which requirements in the ISAs, in particular those that address risk assessment and the audit of highly judgmental or subjective areas, are designed effectively and use appropriate terminology and language to drive appropriate auditor behavior.
 - Whether guidance can be developed to support auditors in their consideration of whether they have appropriately applied professional skepticism in the context of an individual engagement – for example, has enough of the right kind of work been done, and at the right time, as a basis for the auditor's conclusions?
 - Whether there is a need for clarification in the ISAs about what constitutes evidence of the application of professional skepticism and how auditors should document the application of professional skepticism in their working papers.

ISA 540

28. In December 2015 the IAASB approved the commencement of a standard-setting project to revise ISA 540. Matters to be considered by the ISA 540 Task Force that are likely to impact or be impacted by the ISA 315 (Revised) project include:
- The link between the degree of estimation uncertainty of an accounting estimate and whether that accounting estimate is a significant risk.
 - Considering how unintentional and intentional management bias when evaluating the reasonableness of management's accounting estimate is taken into account in the auditor's risk assessment procedures.

³¹ Invitation to Comment—*Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*

In addition, the questions identified in paragraph 17 of this paper will also be particularly relevant to the ISA 540 project.

Data Analytics

29. The Board has established a separate working group to undertake initial work related to identifying matters relevant to the ISAs regarding developments in technology, particularly data analytics.
30. From outreach conducted to date by the Data Analytics Working Group (DAWG), the use of data analytics in an audit may be an effective tool to be able to gain the understanding of the entity and its environment required by ISA 315 (Revised). For example, in executing the requirements in ISA 315 (Revised) to understand the entity's internal controls, the auditor may follow transactions through the financial reporting process to understand the transaction flow. These procedures are currently performed primarily from discussions with the entity and following a sample of transactions through the financial reporting process. Using data analytics, tools are available to analyze all transactions in a particular process for an entire audit period, allowing the auditor to visualize all the paths the transaction took. This allows the auditor to see what actually occurred, and not focus only on what should be occurring.
31. As the ISA 315 (Revised) WG commences its activities, it will liaise with the DAWG on areas of common interest.

Group Audits

32. The ITC also discusses matters related to Group Audits and the interactions of ISA 600 with ISA 315 (Revised).
33. In the context of a Group Audit, issues have been identified related to the identification of significant risks and significant components. These include:
 - (a) Risks identified at the component level by the component auditors are sometimes not appropriately considered at the group level (i.e., inappropriate consideration is given as to whether such risks are group-wide risks or whether such risks also exist at some or all of the other components).
 - (b) In situations where group-wide significant risks have been identified that relate to all components, including non-significant components where no procedures are planned to be performed, it may be unclear as to where, or to which component, the work related to the significant risk is to be directed in order to appropriately respond to the risk.
 - (c) The interaction of "significant risks" and "significant components,"³² i.e., how the identification of significant risks at a component impacts the determination as to whether a component is a significant component. Significant components are identified either based on financial metrics or whether components are likely to include significant risks (determined in accordance with ISA 315 (Revised)).³³ As identification and assessment of significant risks is also linked to the identification of significant components, it has been noted that ISA 600 does not provide much detail as to how significant risks that are pervasive to the group (and which therefore potentially exist at all

³² A "significant component" is described as a component that is of individual financial significance to the group, or that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement in the group financial statements (see paragraph 9(m) of ISA 600) (ITC paragraph 245).

³³ ISA 600, paragraphs 26–27

components) are to be taken into account in determining which components are to be considered significant. It has been noted that the relevant definitions may need to be reconsidered.

34. The requirements for identifying significant risks in an audit engagement are contained in paragraphs 27–29 of ISA 315 (Revised), with related application material in paragraphs A132–A136. Although there are no specific requirements or guidance in ISA 600 for identifying significant risks in a group audit situation, the group engagement team would be expected to refer to ISA 315 (Revised) in this regard in the context of the group audit engagement.³⁴ In addition, ISA 315 (Revised) also requires that, if the auditor has determined a risk to be a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities, relevant to that risk.³⁵
35. As noted in the ITC, the IAASB is of the view that the requirements in ISA 600 and the related application material, as well as the overarching requirement in paragraph 11(a) and guidance in A26 of ISA 315 (Revised), would adequately require auditors of group financial statements to obtain the necessary understanding of the entity and its environment in order to identify and assess the risks of material misstatement at both the group and component level.³⁶
36. However, it is recognized that improvements are likely needed to ISA 600 to make the link clearer. Accordingly, the ITC discusses the following possible actions to address the issues related to ISA 315 (Revised):
- Enhancing ISA 600 to make more explicit reference to the principles, requirements and related application material in ISA 315 (Revised), including adding more application material to ISA 600 to explain how the requirements in ISA 315 (Revised) might apply in the context of a group audit.
 - Providing additional examples for relevant aspects and principles in ISA 315 (Revised) that may arise from a group audit. These changes may help reinforce that the understanding of the group and its components builds upon the requirements in ISA 315 (Revised), and the responses to the assessed risks of material misstatement are to be framed in terms of ISA 330, which may therefore help the group engagement team in better considering all aspects of where such risks may exist in a group audit, and in how those risks should be responded to, including at the component level.³⁷
 - Considering whether more application material could be included in ISA 600 about consideration of internal control relevant to the audit and the entity's financial reporting process used to prepare the consolidated financial statements through making a more direct link to relevant requirements and application material in ISA 315 (Revised).

V. Staff Exercise – Comparison between ISA 315 (Revised) and the U.S. Public Company Accounting Oversight Board's (PCOAB's) Auditing Standard (AS) 12³⁸

37. A review of corresponding national auditing standards, to determine whether they incorporate additional requirements or guidance than what is in the extant ISA, is helpful in understanding where

³⁴ ITC paragraph 249

³⁵ ISA 315 (Revised), paragraph 29

³⁶ ITC paragraph 251

³⁷ ITC paragraph 253

³⁸ PCAOB Auditing Standard (AS) No. 12, *Identifying and Assessing Risks of Material Misstatement*

there may be areas in the ISA that require further consideration. As an initial step, Staff has undertaken an initial comparison between ISA 315 (Revised) and AS12. Staff is also planning a discussion with NSS group at its June 2016 meeting to gather additional information regarding additional requirements or guidance incorporated by national auditing standards in their ISA 315 (Revised) equivalents.

38. In 2010, the PCAOB adopted eight auditing standards related to the auditor's assessment and response to risk in an audit. The suite of risk assessment standards, AS No. 8³⁹ through AS No. 15⁴⁰, set forth requirements that enhance the effectiveness of the auditor's assessment and response to the risks of material misstatement in the financial statements. AS 12 specifically addresses the identification and assessment of risks of material misstatement, and is the PCAOB's equivalent of ISA 315 (Revised).
39. Staff have performed a preliminary analysis of the differences between ISA 315 (Revised) and AS 12. The table below identifies those differences.

Differences Identified between ISA 315 (Revised) and AS 12
The requirement in AS 12 ⁴¹ to obtain an understanding of how changes in the company from prior periods affect risks of material misstatements is presented in ISA 315 (Revised) as application material rather than a requirement. ⁴²
AS 12 presents a list of additional audit procedures that the auditor should consider performing ⁴³ (i.e., a requirement) while obtaining an understanding of the company and its environment. ISA 315 (Revised) has no such requirement, although application material in ISA 315 (Revised) cites reviewing information obtained from external sources, such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications as a procedure that might be helpful in identifying risks of material misstatement.
AS 12 requires the auditor to obtain an understanding of the company's selection and application of accounting principles, ⁴⁴ including disclosures. ⁴⁵ AS 12 includes a list of matters that the auditor should understand (i.e., a requirement) in relation to the company's selection and application of accounting principles. The requirement in ISA 315 (Revised) paragraph 11 is generally consistent except that AS 12 emphasizes the need to consider disclosures. In addition, ISA 315 (Revised) goes beyond AS 12 to state the auditor needs to understand the reason for the changes in accounting principles.
In obtaining an understanding of the control environment, ISA 315 (Revised) paragraph 14 requires the auditor to evaluate whether (a) management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and (b) the

³⁹ PCAOB AS No. 8, *Audit Risk*

⁴⁰ PCAOB AS No. 15, *Audit Evidence*

⁴¹ PCAOB AS 12, paragraph 8

⁴² ISA 315 (Revised) paragraphs A19 and A32

⁴³ PCAOB AS 12, paragraph 7

⁴⁴ Referred to as accounting policies in the ISAs.

⁴⁵ PCAOB AS 12, paragraph 12

Differences Identified between ISA 315 (Revised) and AS 12

strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by control environment weaknesses.

AS 12 requires an additional assessment related to the control environment, but the requirement is aligned more closely with AS 5.⁴⁶ Paragraph 25 of AS 12 states if the auditor identifies a control deficiency in the company's control environment, the auditor shall evaluate the extent to which this deficiency is indicative of a fraud risk factor.

ISA 315 (Revised) does not contain a similar requirement or application material addressing this topic.

AS 12 paragraph 47 requires the auditor to perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.

ISA 315 (Revised) does not contain a similar requirement or application material addressing this topic. However, ISA 240⁴⁷ contains a rebuttable presumption that there are risks of fraud in revenue recognition, and that the auditor needs to assess which types of revenue, revenue transactions or assertions give rise to such risks and treat those risks as significant risks.

AS 12 does not include the information contained in appendix 1 of ISA 315 (Revised), containing descriptions of the components of internal control over financial reporting and examples of conditions and events that could indicate risks of misstatement. Instead, AS 12 paragraph 22 directs auditors to the applicable internal control framework for information about internal control components.

AS 12 also does not include the information contained in the appendix 2 of ISA 315 (Revised) that lists risk indicators.

AS 12 and ISA 315 (revised) both require the auditor to obtain an understanding of the company's risk assessment process as part of obtaining an understanding of internal control. ISA 315 (Revised) contains additional requirements for situations in which the company has no formal risk assessment process or a lack of documentation regarding the process. AS 12 does not include these additional requirements because it is not necessary for the standards of audits of issuers⁴⁸ to impose specific requirements based on the level of formality or documentation of the risk assessment component of internal control over financial reporting.

ISA 315 (Revised) requires the risk assessment procedures to include inquiries of management and others, analytical procedures, and observation and inspection. AS 12 does not include this requirement. Rather, the requirements, by their nature, should lead the auditor to perform a combination of those types of procedures.

⁴⁶ PCAOB AS 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

⁴⁷ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an audit of Financial Statements*, paragraphs 26–27

⁴⁸ PCAOB Rule 1001(i)(iii) - Definition of Issuer - The term "issuer" means an issuer (as defined in Section 3 of the U.S. Securities Exchange Act of 1934), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the U.S. Securities Act of 1933, and that it has not withdrawn.

40. Another important difference between the PCAOB Auditing Standards and the ISAs is that PCAOB Auditing Standards contain key principles for responding to the risks of material misstatements in an integrated audit. That is, PCAOB Auditing Standards direct the auditor to design tests of controls to meet the objectives of both the audit of financial statements and the audit of internal control over financial reporting. The ISAs only address audits of financial statements. Therefore, as the ISA 315 (Revised) project moves forward, the ISA 315 (Revised) WG could consider the differences identified in paragraph 39 of this paper and assess whether it may be appropriate to strengthen the requirements in ISA 315 (Revised) (for example, perhaps by elevating application material in ISA 315 (Revised) to requirements).

VI. Other Resources for Consideration

41. In addition to the input to be provided by WG members, including those WG members who are associated with firms and NSS that may have already addressed some of the challenges with ISA 315 (Revised) through development of risk assessment methodologies and logical sequencing and workflow, other resources that could be of assistance to the WG are as follows.

- (a) An Institute of Chartered Accountants in England and Wales (ICAEW) publication titled '*Risk assessment and internal controls: continuing challenges for auditors*'.

The publication brings together three articles on risk assessment and internal controls, written with the input of ICAEW members in practice. The articles deal with practical implementation issues and discuss the continuing challenges highlighted in regulatory reports, and in discussions between auditors, standard setters and regulators.

- (b) International Federation of Accountants '*Guide to Using ISA's in the Audits of Small-and Medium-Sized Entities*.'

This [implementation guide](#) is intended to help practitioners understand and efficiently apply the ISAs to audits of SMEs.

Matters for IAASB Consideration

1. Are there any other considerations (for example, developments of internal control frameworks) or aspects relating to requirements and guidance that should be taken into account by the WG as it commences its activities?
2. The IAASB is asked for views on the matters relating to the ISA Implementation Monitoring findings and other practice matters noted in **Sections II** and **III**, respectively, of this paper. Specifically:
 - (a) Board members are asked to provide views on which of the matters should be prioritized?
 - (b) Are Board members aware of steps that have been taken by NSS, practitioners or others to respond to some of these challenges? If so, what has been the effect these steps have had related to the practical application of ISA 315 (Revised)?

3. Does the IAASB agree with the interactions with completed and ongoing IAASB projects identified in **Section IV**? Are there other interactions with IAASB projects that Board members believe should be considered?
4. The IAASB is asked to provide its views on the possible actions the WG might consider related to the differences identified between ISA 315 (Revised) and AS 12 in **Section V** of this paper.
5. The IAASB is asked to provide suggestions for resources the WG should consider in addition to those highlighted in **Section VI** of this paper.

Appendix

Illustration of improved description of the responsibilities of the auditor and key features of an audit in the auditor's report

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.⁴⁹
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

⁴⁹ This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.