Agenda Item 4

ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatements*

Objective of Agenda Item

To obtain feedback from the Auditing Standards Board (ASB) on the draft of proposed Statement on Auditing Standards (SAS), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

Task Force

The Task Force members are as follows:

- Tracy Harding–BerryDunn, Chair
- Dora Burzenski (supported by Sally Ann Bailey)–Deloitte
- Diane Hardesty–EY
- Kathy Healy–PwC
- Susan Jones–KPMG
- April King–RSM
- Maria Manasses–GT
- Dan Wernke–Clark Schaefer Hackett

Bob Dohrer, Chief Auditor, AICPA, serves as an observer to the task force. In addition, Jon Heath, ASB member, has been involved as an IT subject matter expert.

Background

In March 2009, the IAASB completed its Clarity Project, designed to improve the clarity and understandability of the International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC) 1, thereby facilitating their consistent application. One of the initiatives in the IAASB's Strategy and Work Program 2009–2011 was the development of a process for assessing the effectiveness of the implementation of the clarified ISAs.

The post-implementation review of the clarified ISAs was completed in 2013, and the findings from this review formed the basis for the IAASB's Strategy and Work Plans in 2015–2019. Findings with regard to ISA 315 (Revised) (extant ISA 315) suggested that reconsideration of the standard was needed as the comments received indicated that several aspects of the standard were not being understood or implemented in a consistent manner. Accordingly, the Board included planned work on extant ISA 315 in its Strategy and Work Plans for 2015–2019.

The ISA 315 Working Group commenced work in early March 2016 and undertook outreach with a wide group of stakeholders to further inform preliminary thinking on the issues identified

by the ISA Implementation Monitoring Project related to ISA 315 (Revised). Auditors of small- and medium-sized entities (SMEs) noted specific challenges from a scalability perspective in effectively and efficiently applying extant ISA 315. One of the more significant challenges related to the extent to which understanding an entity's internal control is necessary when the auditor does not intend to rely on the operating effectiveness of the entity's controls. Inspection findings by audit regulatory and oversight bodies consistently highlighted issues related to auditor risk assessments, including the work performed to understand internal control, identify significant risks and consider and respond to information technology (IT) risks. The IAASB approved a project to revise extant ISA 315 in September 2016.

In July 2018, the IAASB issued an Exposure Draft that included a proposal to revise ISA 315, *Identifying and Assessing the Risks of Material Misstatements,* (ISA 315). The comment period ended November 2, 2018.

At its meeting in September 2019, the IAASB approved the proposed ISA 315 as a final standard, including conforming amendments to other ISAs. The standard will be effective for audits of financial statements for periods beginning on or after December 15, 2021.

At the October 2019 ASB meeting, the Task Force presented preliminary issues identified by the Task Force. Significant comments or observations by the ASB members were as follows:

- Mr. Harding highlighted the major changes in ISA 315, which the Task Force is supportive of: 1) new requirement to make separate assessments of inherent and control risk, 2) the introduction of the spectrum of inherent risk, 3) revised definition of significant risk, and 4) new requirement for the auditor to stand-back and reevaluate material classes of transaction, account balances, and disclosures that have not been assessed as significant. The ASB concurred with the Task Force's views.

- He highlighted the requirements in ISA 315 in which the auditor is required to perform risk assessment procedures to understand internal control. Related to gaining an understanding of internal control is the application material that describes the components of internal control. The ASB discussed whether this application material should be revised by the Task Force to be more aligned with the COSO framework. After discussion, the ASB agreed to an approach in which the application material as described in ISA 315 is retained, but a document will be created that compares the application material in the revised AU-C 315 and the COSO framework.

- He highlighted the requirements in which the auditor would gain an understanding of each component of internal control. After discussion, the ASB was supportive of the requirements in ISA 315. However, a member raised the issue about information technology general controls (ITGC) and how they affect direct and indirect controls. The Task Force will specifically focus on this when drafting proposed changes to the AU-C.

- He highlighted the requirements to identify and assess the risks of material misstatement. The ASB expressed support for the requirements in ISA 315. But, in doing that, the ASB agreed that the requirement in extant AU-C 315 to assess and respond to the risks of material misstatement should be at the *relevant assertion* level as opposed to the requirement in ISA 315 that the assessment should be at the *assertion level*.

- The ASB discussed the issue whether paragraph 18 of AU-C 330 should be retained in light of the enhancements to AU-C 315. However, the ASB cautioned that the deletion of this paragraph from AU-C 330 might be interpreted as ISA-minus. Accordingly, this paragraph should be retained, including the extant difference from ISA 315 in that the requirement to perform substantive procedures applies to all *relevant* assertions related to material classes of transactions, account balances, and disclosures.
- The Task Force will present a draft proposed SAS at the ASB's next physical meeting in January 2020.

Matters for the ASB's Consideration

I. Components of Internal Control

ASB Comment	*Task Force Disposition*
ISA 315 requires the auditor to perform risk assessment procedures to understand internal control. Related to gaining an understanding of internal control is the application material that describes the components of internal control. The ASB discussed whether this application material should be revised by the Task Force to be more aligned with the COSO framework. After discussion, the ASB agreed to an approach in which the application material as described in ISA 315 is retained, but a document will be created that compares the application material in the revised AU-C 315 and the COSO framework	The Task Force agreed with the ASB's recommendation and no significant edits were made to the application material addressing the components of internal control.

II. Gaining an Understanding of Internal Control

He highlighted the requirements in which the auditor would gain an understanding of each component of internal control. After discussion, the ASB was supportive of the requirements in ISA 315. However, a member raised the issue about information technology general controls (ITGC) and how they affect direct and indirect controls. The Task Force will specifically focus on this when drafting proposed changes to the AU-C.	The proposed SAS distinguishes the components of internal control as indirect or direct components. Controls within the control environment, the entity's risk assessment, and the process to monitor the system of internal components are referred to as indirect controls, and controls within the information system and communication and control activities components are referred to as direct controls. Paragraph 26*a* of the proposed SAS requires the auditor to identify controls that address the risks of material misstatement. Based on the identified controls, the auditor is required to identify IT application controls that may support those identified controls (paragraph 26*b*), and from such applications controls, the auditor is

	required to identify the ITGC that support those application controls (paragraph 26*c*). Therefore, under the proposed SAS, the identification of ITGC falls under the control activities component. An ASB member raised the issue whether there might be ITGCs in other components, for example, the information system and communication component. Paragraph A147 states the following: > The control activities component includes controls that are designed to ensure the proper application of policies (which are also controls) in all the other components of the entity's system of internal control, and includes both direct and indirect controls Paragraph A148 further states: > The auditor's identification and evaluation of controls in the control activities component is focused on information processing controls, which are controls applied during the processing of information in the entity's information system that directly address risks to the integrity of information. The Task Force believes that these application material paragraphs address the issue of whether ITGC may exist within components of internal control other than the control activities component. But, the Task Force discussed whether an additional example might be useful to illustrate an ITGC that exists, for example, in the information system and communication component. The Task Force decided that this example would be better included in the Audit Guide where the example can be more fully developed and explained.

III. Identifying and Assessing the Risks of Material Misstatements

ASB Comment	*Task Force Disposition*
He highlighted the requirements to identify and assess the risks of material misstatement. The ASB expressed support for the requirements in ISA 315.	*ISA 315 Definition*:

ASB Comment	*Task Force Disposition*
But, in doing that, the ASB agreed that the requirement in extant AU-C 315 to assess and respond to the risks of material misstatement should be at the *relevant assertion* level as opposed to the requirement in ISA 315 that the assessment should be at the *assertion level.*	**Relevant assertions** – An assertion about a class of transactions, account balance or disclosure is relevant when it has an identified risk of material misstatement. The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (i.e., the inherent risk). *Extant AU-C 315 Definition* **Relevant Assertion.** 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 made without regard to the effect of internal controls. The Task Force deliberated whether to retain the extant definition of relevant assertion and after discussion agreed to retain the term in ISA 315, that is, use the term *assertion* instead of changing to *relevant assertion.* This is because changing it might have unintended consequences. Furthermore, the term "level" is intended to distinguish between financial statement and assertion level. The concept of reasonable possibility is captured in the definition of risks of material misstatement, and a reminder of this fact has been added to the "Key Concepts" section and to application material related to the definition of relevant assertions in paragraph 12.

Questions for the ASB

1. What are the ASB's views with respect to the Task Force's disposition of the Board's input regarding the components of internal control, gaining an understanding of internal control, and identifying and assessing the risks of material misstatement?

IV. Paragraph 18 of AU-C 330

Background of the Issue

The following table is a comparison between ISA 315 and AU-C 315 of the relevant paragraphs:

	ISA 315	**AU-C 315**
Assertions	Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.	Representations by management, explicit or otherwise, that are embodied in the financial statements as used by the auditor to consider the different types of potential misstatements that may occur.
Relevant assertions	An assertion about a class of transactions, account balance or disclosure is relevant when it has an identified risk of material misstatement. The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (i.e., the inherent risk).	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 made without regard to the effect of internal controls.
Conforming amendment to AU-C 200	Risk of Material Misstatement (Ref: Para. 13(n)) A15a. For the purposes of the ISAs, a risk of material misstatement exists when: (a) There is a reasonable possibility of a misstatement occurring (i.e., its likelihood); and	

	(b) If it were to occur, there is a reasonable possibility of the misstatement being material (i.e., its magnitude).	
Assessment of risks of material misstatement	28. The auditor should identify the risks of material misstatement and determine whether they exist at: (Ref: par. A176–A184) *a.* The financial statement level; (Ref: par. A185–A192) or *b.* The assertion level for classes of transactions, account balances and disclosures. (Ref: par. A193)	.26 To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at a. the financial statement level and (Ref: par. .A122–.A125) b. the relevant assertion level for classes of transactions, account balances, and disclosures. (Ref: par. .A126–.A133)
Stand-back requirement	36. For material classes of transactions, account balances or disclosures that have not been determined to be significant classes of transactions, account balances or disclosures, the auditor should evaluate whether the auditor's determination remains appropriate.	
	A234. There may be classes of transactions, account balances or disclosures that are material but have not been determined to be significant classes of transactions, account balances or disclosures (that is, there are no relevant assertions identified). Example: The entity may have a disclosure about executive compensation for which the auditor has not identified a risk of material misstatement. However, the auditor may determine that this disclosure is material based on the	

	considerations in paragraph A233. A235. Audit procedures to address classes of transactions, account balances or disclosures that are material but are not determined to be significant are addressed in AU-C section 330. When a class of transactions, account balance or disclosure is determined to be significant as required by paragraph 29, the class of transactions, account balance or disclosure is also a material class of transactions, account balance or disclosure for the purposes of paragraph 18 of AU-C section 330.	
AU-C 330	18 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.	18. Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. (Ref: par. .A45–.A50)

The IAASB introduced paragraph 36 (and the related application material) in ISA 315 and effectively represents a stand-back requirement. This stand-back is

- Intended to drive an evaluation of the completeness of the significant classes of transactions, account balances and disclosures identified by the auditor. In turn, it was intended that this help drive the completeness of the identification of the risks of material misstatement.
- Focused on material classes of transactions, account balances, or disclosures that have not been determined to be significant (i.e., the auditor has not identified any risks of material misstatement that are reasonably possible and therefore for which there are no relevant assertions).

Paragraph 18 of ISA 330 is targeted at *material* classes of transactions, account balances and disclosures, and requires substantive procedures for all such classes of transactions, account balances and disclosures. Thus, the new stand-back requirement in ISA 315 provides a more direct linkage to paragraph 18 of ISA 330.

In the ASB comment letter in response to the exposure draft of the proposed ISA 315, the ASB included the following comment:

> Paragraph 18 of ISA 330 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." We believe that this requirement is counterintuitive to, and may undermine the effectiveness of, the risk assessment process in ISA 315, particularly in view of the enhancements being proposed by ED-315. That is, the auditor is required to identify and assess the risks of material misstatement in order to design tailored audit responses. In addition, the stand-back requirement in ED-315 paragraph 52 provides an opportunity to again consider the assessed risks, with a specific focus on material classes of transactions, account balances, and disclosures that the auditor has not identified as significant. If an auditor would be required to perform substantive audit procedures regardless of the assessment of risks of material misstatement under ISA 315, then the objective of performing the work effort under ISA 315 could be questioned. Accordingly, we recommend that paragraph 18 of ISA 330 be eliminated.
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> In addition, if paragraph 18 of ISA 330 is retained, we recommend application material be added to provide guidance as to how the auditor should determine which assertions should be addressed in designing and performing further audit procedures, given that this requirement only applies to classes of transactions, account balances and disclosures that the auditor has determined, through the ISA 315 process, do not contain relevant assertions.

Also, under AU-C 315 and AU-C 330, the auditor is required to assess the risks of material misstatement at the *relevant* assertion level and design and perform further audit procedures for all *relevant* assertions related to each material class of transactions, account balance, and disclosure. This construct was taken from the PCAOB at the time the original risk assessment standard were issued by the ASB. This is a difference that exists today between the extant ISAs and the AU-Cs.

October 2019 ASB Meeting Highlights

At the October 2019 ASB meeting, the ASB decided that paragraph 18 of AU-C 330 should be retained because deleting this paragraph from AU-C 330 might be interpreted as ISA-minus. In doing that, the ASB decided to retain the current requirements in AU-C 315 and AU-C 315 that drive the work effort at the *relevant* assertion level.

Task Force Views

As explained above, paragraph 36 of ISA 315 is intended to be a stand-back requirement for the auditor to reaffirm his or her initial identification of significant classes of transactions, account balances, and disclosures (SCOTABDs). A SCOTABD is defined as a class of transactions,

account balance, and disclosure with at least one relevant assertion. And a relevant assertion is defined as an assertion with an identified risk of material misstatement.

The stand-back requirement also is intended for the auditor to identify classes of transactions, account balances, and disclosures that have not been identified as SCOTABDs. Because paragraph 18 of ISA 330 is targeted at the material classes of transaction, account balances, and disclosures, the stand-back requirement (paragraph 36 of ISA 315) provides a more direct linkage between ISA 315 and ISA 330.

As noted in the highlights of the October ASB meeting, the ASB decided to retain paragraph 18 of AU-C 330. In GAAS, there is a different between extant paragraph 18 of ISA 330 and extant paragraph 18 of AU-C 330 because under paragraph 18 of AU-C 330 the auditor is required to design and perform further audit procedures for *all relevant assertions related to each* material class of transaction, account balance, and disclosure. In further deliberations, the Task Force believes AU-C 330 should be amended to require the auditor to design and perform substantive procedures for all relevant assertions related to each *significant* (instead of material) class of transactions, account balance, and disclosure. This would align paragraph 18 of AU-C 330 more to the PCAOB standard.

Questions for the ASB

2. What are the ASB's views with respect to the Task Force's recommendation to revise paragraph 18 of AU-C 318?

Other Matters

Effective Date

The effective date of the proposed SAS would be for audits of financial statements for periods beginning on or after December 15, 2021. For context, the following ongoing projects (and the preliminary effective dates) are closely linked to this proposed SAS:

.*a* Audit Evidence–for audits of financial statements for periods beginning on or after December 15, 2021
.*b* Auditing Accounting Estimates–audits of financial statements for periods ending on or after December 15, 2022

Examples

The application material of the proposed SAS contains several examples that are presented in boxes. This presentation is new and intended to better highlight the examples within the application material.

Variable Interest Entities

The extant standard references *special-purpose entities*. The Task Force decided to change this term to *variable interest entities* to reflect changes in GAAP in recent years

Appendix 1 of the proposed SAS explains the objectives and scope of the entity's business model and provides examples of matters that the auditor may consider in understanding the

activities of the entity that may be included in the business model. Paragraphs 6 and 7 specifically provide guidance about variable purpose entities and read as follows:

Nature of Variable Interest Entities

6. A variable interest is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the variable interest entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As AU-C section 550 indicates, in some circumstances, a variable interest entity may be a related party of the entity.

7. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the variable interest entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the variable interest entity.

Note: footnote intentionally omitted

Given the changes in accounting rules in this area since this guidance was written, an issue is whether paragraphs 6 and 7 are still necessary. Therefore, should these paragraphs be deleted?

Questions for the ASB

3. What are the ASB's views with respect to a) the proposed effective date of the proposed SAS, b) the examples presented in boxes in the application material, c) the deletion of the paragraphs that deal with variable interest entities?

Items Presented

Agenda Item 4 – Issues Paper

Agenda Item 4A – Proposed SAS, marked from ISA 315

Mr. Harding will refer to the Agenda Items 4 and 4A in leading the discussion.