



Agenda Item 4

AU-C 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*

Objective of Agenda Item

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

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 January 2020 meeting, the Task Force presented preliminary issues identified by the Task Force. Significant comments or observations by the ASB members were as follows:

- A member expressed a concern that the proposed standard differs from the PCAOB standard, in particular with respect to gaining an understanding of the internal control components. The proposed standard differentiates between indirect and direct components of internal control. Such differentiation does not exist in the PCAOB standard. As a result of these differences, it will be harder for auditors to navigate two sets of standards, ASB and PCAOB. Mr. Harding explained that the intent of the distinction was to acknowledge certain components have a less direct impact on the financial statement risks, but still have an indirect impact, so an understanding and evaluation of the items listed under each component is important to identify and assess risks of material misstatement. He asked that the Board focus on whether the work effort required in each component is clear; see further comments below.
- Mr. Harding explained that the Task Force proposes to make a conforming amendment to paragraph 18 of AU-C section 330 to align it more with the PCAOB standard by proposing an amendment to change paragraph 18 of AU-C section to refer to *significant* class of transactions, account balance, and disclosure, instead to *material* class of transactions, account balance, and disclosure. The ASB discussed the differences that currently exists between paragraph 18 of AU-C section 330 and paragraph 18 of ISA 315. After discussion, the ASB was supportive of the Task Force's proposal, but directed the Task Force to further consider making edits to paragraph 18 of AU-C section 330 to make the requirement clearer.
- On the matter of variable interest entities, a member noted that content of variable interest entities seems to be aligned with IFRS and suggested that the Task Force consult with FinRec to make sure the content is consistent with GAAP.

Risk Assessment Issues
ASB Meeting, May 18-21, 2020

- With respect to the examples in the proposed standard, a member asked whether these examples could be relocated to the audit guide. Mr. Harding explained that the Task Force believes that, to the extent the example is necessary to explain more fully explained the application material, it should be retained in the proposed standard. After discussion, the ASB decided to keep the examples in the proposed SAS, but the examples could be further explained in the audit guide.
- Mr. Harding led a review of the proposed standard. The following were the significant matters discussed by the ASB:
 - Gaining an understanding of the components of internal control—for each of the components of internal control, the auditor will be required to gain an understanding of certain matters related to each component of internal control and evaluate certain aspects of the controls within each component. A member expressed concern about the term “evaluate.” He explained that as articulated, the term “evaluate” seems to convey that the auditor would have to perform procedures similar to the procedures that the auditor would be required to evaluate design and implementation of controls (D&I procedures). Mr. Harding explained that paragraph 26d contains the explicit requirement for the auditor to perform D&I procedures, which relates to the control activities component, and that the proposed SAS explains that 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. A member expressed caution about changing the terminology in the requirement but suggested that the Task Force consider adding application material to better explain the work effort required in gaining an understanding of the components of internal control and performing the required evaluation, including D&I procedures when required.
 - Paragraph A109a explains that in obtaining an understanding of the entity’s risk assessment process, AU-C section 240 also requires the auditor to make inquiries of management regarding, among other things, management’s process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist. A member asked the question whether this guidance suggests that the auditor would be required to obtain an understanding of controls and perform D&I procedures on controls within the entity’s risk assessment process (similar issue as discussed above).
 - Mr. Harding highlighted that paragraph 25c has been edited by the Task Force to explicitly note that the auditor’s evaluation of the information and communication component is based on the understanding in sub-paragraphs 25a-b. A member expressed concern about this edit, because the auditor’s understanding of the information and communication component may not necessarily be limited to the understanding required under sub-paragraphs 25a-b. The ASB directed the Task Force to further consider this comment.
 - A member raised the issue whether the Task Force considered the requirement in extant AU-C section 315 that requires the auditor to obtain an understanding of

the process of reconciling detailed records to the general ledger for material account balances. Mr. Harding explained that it was the Task Force's view that this requirement is addressed in paragraph 25. The Task Force was directed to keep this requirement as a sub-paragraph to paragraph 26.

- A member recommended the Task Force consider language to clarify the "controls over journal entries" referenced in paragraph 26a(ii), as many entities use journal entries to record routine transactions such as revenue and expenses. The Task Force will explore language that distinguishes processing of routine transactions from other adjustments to accounting records used to prepare financial statements.
- Mr. Harding requested feedback about the "catchall" category of controls in the control activities component described in paragraph 26a(iv). A member suggested the Task Force include application material referencing estimates as a potential example of an area that may involve such controls, in a manner consistent with guidance in the Estimates ED.

Matters for the ASB's Consideration

Gaining an Understanding of the Components of Internal Control – Work Effort

Under the proposed SAS, the auditor will be required to gain an understanding of certain matters related to each component of internal control and evaluate certain aspects of the controls within each component (see paragraphs 21 – 26). At the January meeting, a member expressed concern about the term "evaluate" used in this context because the work effort in gaining an understanding of the components of internal control seems indistinguishable from the work effort required to evaluate design and implementation of controls (see paragraph 26d of the proposed SAS).

The Task Force revisited this issue. Members of the Task Force who participated in the ISA 315 project expressed the view that the evaluation required for the control environment, the entity's risk assessment process, and the entity's process for monitoring the system of internal control was not intended to require the auditor to perform D&I procedures. Rather, the requirements in each of those components of internal control outline the work effort that the auditor would be required to perform in order to gain an understanding of those components. Paragraph A104 explains this work effort as it relates to the control environment component:

A104. The auditor's evaluation of the control environment is based on the understanding obtained in accordance with paragraph 21(a).

Each of the other components has the same explanation.

At the January ASB meeting, the Board discussed moving the condition set forth in paragraph A104 to the related requirement (paragraph 21). Upon further deliberations, the Task Force suggests keeping this condition in the application material, because some Task Force members believed that to include it in the requirement might be read as prohibiting the auditor from considering other information and thus could be viewed as a difference from the ISA requirements.

The work effort with respect to gaining an understanding of each of the components of internal control is distinguished from the explicit D&I procedures in paragraph 26d with respect to control activities, as a D&I work effort for the other components might involve consideration of control objectives that is not required by the proposed SAS. To make this difference clearer, the Task Force suggests the following edits to paragraph A90 of the proposed SAS:

A90. The auditor's understanding of the entity's system of internal control is obtained through risk assessment procedures performed to understand and evaluate each of the components of the system of internal control as set out in paragraphs 21 to 27. ***For the control activities component of internal control, this requires performing risk assessment procedures to evaluate whether the controls are effectively designed and determine whether the controls have been implemented in accordance with paragraph 26d of this proposed SAS.***

Paragraph A95 explains that the auditor's understanding of each of the components of internal provides a preliminary understanding how the entity identifies business risks. The Task Force suggests making further edits to paragraph A95 to make it clear that this understanding informs the auditor's D&I for the control activities component. As revised, paragraph A95 reads, in part, as follows:

The auditor's understanding of each of the components of the entity's system of internal control provides a preliminary understanding of how the entity identifies business risks and how it responds to them and ***in evaluating the effectiveness of the design of controls and determining whether the controls have been implemented in the control activities component*** (see paragraph 26d)...

Questions for the ASB

1. What are the ASB's views with respect to the changes to the application material to clarify the difference between the work effort on gaining an understanding of the other components of internal control and performing procedures to evaluate the design of controls and determine whether they are implemented in the control activities component?

Conforming Amendment to Paragraph 18 of AU-C 330

Paragraph 36 of ISA 315 establishes 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. 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 consider whether material classes of transactions, account balances, and disclosures that have not been identified as SCOTABDs should be identified as such. Because paragraph 18 of ISA 330 is also targeted at material classes of transactions, account balances, and disclosures, the stand-back requirement (paragraph 36 of ISA 315) provides a more direct linkage between ISA 315 and ISA 330.

Risk Assessment Issues
ASB Meeting, May 18-21, 2020

As noted in the highlights of the October 2019 ASB meeting, the ASB decided to retain paragraph 18 of AU-C 330. There is a difference between extant paragraph 18 of ISA 330 (pre- and post revised ISA 315) and extant paragraph 18 of AU-C 330 because under paragraph 18 of AU-C 330 the auditor is required to design and perform substantive procedures for *all relevant assertions related to each* material class of transaction, account balance, and disclosure. At the January meeting, the ASB agreed with the Task Force's recommendation that AU-C 330 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. In further deliberations, the Task Force discussed modifications to the wording of the conforming amendment to paragraph 18 of AU-C 330 to better align with the wording in PCAOB standard AS 2301; accordingly, the Task Force recommends the following language:

18. ~~Irrespective of the assessed risks of material misstatement, T~~he auditor should design and perform substantive procedures for *each* all relevant assertions related to each material *significant* class of transactions, account balance, and disclosure, *regardless of the assessed level of control risk.*

Questions for the ASB

2. What are the ASB's views with respect to the proposed conforming amendment to paragraph 18 of AU-C 330 to fully align it with AS 2301?

Effective Date

The proposed effective date is for audits of financial statements for periods ending on or after December 15, 2023. The Task Force believes that it is important for the effective date to be aligned with that of the proposed revisions to AU-C 540, *Accounting Estimates and Related Disclosures*, due to the introduction of certain concepts in that proposed statement that presume corresponding amendments included in the proposed revisions to AU-C 315, and that significant time will likely be required for practitioners and third-party developers to modify their methodologies to reflect the changes to AU-C 315. The Task Force believes it is less critical to align the effective date with that of the proposed SAS on audit evidence.¹

Questions for the ASB

3. What are the ASB's views with respect to the proposed effective date?

Items Presented

1. Agenda Item 4 – Issues Paper
2. Agenda Item 4A – Proposed SAS, marked from ISA 315 (changes since the January 2020 ASB meeting are highlighted in yellow)

¹ Subject to ASB approval, the proposed SAS, *Audit Evidence*, would be effective for audits of financial statements for periods ending on or after December 15, 2022 and proposed SAS, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* would be effective for audits of financial statements for periods ending on or after December 15, 2023.

**Risk Assessment Issues
ASB Meeting, May 18-21, 2020**

3. Agenda Item 4B – Proposed conforming amendments

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