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Professor Arnold Schilder
International Auditing and Assurance
Standards Board
International Federation of Accountants   Our ref   SRA/288
529 Fifth Avenue
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2 November 2018

Dear Professor Schilder

Re: Proposed International Standard on Auditing (ISA) 315 (Revised), Identifying and Assessing the Risks of Material Misstatement, and Proposed Consequential and Conforming Amendments to Other ISAs

We appreciate the opportunity to comment on the above Exposure Draft (ED) issued by the IAASB. We have consulted with, and this letter represents the views of, the KPMG network.

Our overarching comments are set out below. The appendix to this letter provides our responses to the specific questions posed in the ED.

We are supportive of the overall direction of the changes proposed in the ED and the objectives of the IAASB regarding this project. We believe that, in general, the proposals represent considerable enhancements to the extant standard, as together they provide a stronger foundation for the auditor's risk identification and assessment process, as well as introducing greater clarity as to how and why an auditor is to adhere to the requirements. We recognise the significant effort and detailed considerations the IAASB has made in developing the proposals.

In connection with the objective of helping auditors to implement certain requirements of the standard in a more robust and consistent way, the Explanatory Memorandum (EM) notes, at paragraph 30, that significant concerns were highlighted relating to obtaining an understanding of the entity's system of internal control in the IAASB's outreach, including the need for additional clarity to address:

— Why the understanding is required to be obtained (e.g. when a primarily substantive approach to the audit is planned) and how the information obtained is to be used;

— What procedures are required in order to "obtain the necessary understanding" for certain components of internal control;

— Whether all components of internal control need to be understood; and

— When controls are considered "relevant to the audit".

We believe that clarifications regarding the above questions are critically important given the feedback the IAASB received during its outreach procedures and, furthermore, given concerns raised by regulators and national standard setters regarding implementation of the requirements of ISA 315 in this area, such as those described in the ICAEW publication*, Risk Assessment and Internal Controls: Continuing Challenges for Auditors* and the CPA Canada Implementation Tool: *Understanding the entity through internal control*.

We are therefore supportive, in general, of the proposed changes to address the above as we recognise that much of the complexity and scope for inconsistency of application of the requirements of the standard, in practice, lies in obtaining an "understanding" of the entity's system of internal control. As a result, we welcome the improved distinction between an entity's system of internal control, the components within that system of internal control and the controls within each of these components, as well as the improved specificity of requirements pertaining to each of these elements.

We welcome the sequence in which the components of the system of internal control are presented, to include those that consist primarily of "indirect" controls first, followed by those that consist primarily of "direct" controls. This differentiation, together with related "evaluation" requirements in respect of each component, which more specifically explain which aspects of each component an auditor is to understand, is expected to help clarify how the understanding of each component will assist the auditor in identifying and assessing the risks of material misstatement.

We also welcome the clearer delineation between "understanding each of the components of internal control", as set out at paragraph 25, and "identifying the controls [within those components that are] relevant to the audit" and "evaluating the design and implementation of such controls" as set out at paragraph 26. This distinction more clearly articulates that an auditor is required to develop an understanding of the components of internal control for every audit, whether or not controls relevant to the audit have been identified, or are expected to be identified, and irrespective of whether an auditor plans to perform tests of operating effectiveness over such controls.

However, we do have a number of significant concerns relating to certain aspects of the "understanding" section of the ED which we believe may continue to give rise to confusion and inconsistency in application. These aspects are described below and we suggest the IAASB explore our suggestions for further clarity, with a view to providing enhancements to help support their stated objectives.

In considering the ED, much of our understanding of the amendments is informed by the EM, which provides helpful explanations regarding the Board's deliberations and

the rationale for certain conclusions reached, as well as setting out more detail as to how certain requirements are intended to be applied. Accordingly, we suggest that much of this material be included in the final standard to support the aim of achieving consistent application of the standard.

We also provide further details regarding these matters and others in the appendix, in which we set out our responses to the specific questions posed by the IAASB.

Control Activities Component

We note that the Control Activities component does not appear to be a discrete component of an entity's system of internal control in the way that the other four components are. This may give rise to confusion, in particular, because the IAASB does not set out differentiated requirements to first "understand" this component and make a specific "evaluation" based on that understanding, and then to identify controls that are relevant to the audit and to evaluate their design and implementation. Instead, the IAASB describes that the understanding of this component is obtained *by* identifying controls in the component that are relevant to the audit and evaluating the design and implementation of these controls.

As a result, "control activities" and "[direct] controls" (in the Controls Activities component) seem to have the same meaning. We suggest therefore that the IAASB select a single, appropriate term and apply this consistently. If the IAASB intends there to be a difference between these terms, we recommend that the IAASB explicitly clarify this difference.

Distinction Between Controls Within the Control Activities Component and the Information System Controls Relevant to Financial Reporting

As a result of the above, there is a lack of clarity as to how "controls" in the Control Activities component are distinct from "controls" in the other components, in particular, those in the Information System and Communication component. This is compounded by several references in the application material to the fact that "direct" controls, that are designed to prevent, or detect and correct, misstatements at the assertion level, reside mainly in the Information System and Communication component, as well as the Control Activities component.

The EM, at paragraph 35, and application material at A157 and A166, appear to differentiate between the controls in each component by explaining that "controls in the Control Activities component are controls *over* the flows of information and the financial reporting processes", and that it is these controls that primarily comprise the "controls that are relevant to the audit", for which an auditor is required to evaluate the design and implementation. However, we do not consider that this sufficiently clarifies the distinction, and furthermore, we note that paragraph 35 of the EM introduces confusion

by stating that "Information System and Communication, and Control Activities components are comprised primarily of controls that directly address the risks of material misstatement at the assertion level". We therefore recommend that the IAASB further describe the intended inter-relationship between these two components, and the boundary, if any, between the types of controls that reside within each.

We also note that the descriptions of the Control Activities component is different from that set out in the COSO Framework in that within the COSO Framework, this component is clearly defined with the inclusion of related, established principles, and descriptions as to how this component interrelates with, or supports, the other components of the system of internal control.

We highlight that these differences from the COSO Framework, which is a clearly understood framework with a broad global usage, may create confusion, especially given that in other respects the IAASB appears to have sought to increase alignment of key aspects of ISA 315 with the COSO Framework

Scope for Inconsistent Application of Requirements Regarding Obtaining the "Understanding"

We appreciate that the ED is attempting to make a distinction between components of internal control that contain primarily direct versus primarily indirect controls and consequently the work effort required by the auditor for each of these components in order to appropriately identify and assess risks and develop the appropriate responses. Our interpretation of the requirements is that the auditor is required to obtain an understanding of the Control Environment, the entity's Risk Assessment Process, the entity's Process to Monitor the System of Internal Control, and the Information System and Communication components of the entity's system of internal control by performing the procedures set out in the standard but that this understanding does not involve identifying controls, and nor does it involve evaluating the design and implementation of such controls within these components at this point. The auditor is required to identify controls that are relevant to the audit and to evaluate the design and implementation of such controls, at paragraph 39 onwards, based on the understanding obtained.

It would be helpful if the IAASB were to explicitly state this, in order to drive consistency in the application of the requirements of the standard in this area, which is one of the IAASB's stated objectives. In particular, we note that there is scope for confusion and inconsistent application of the requirements in respect of the Information System and Communication component, as we set out below. Additionally, we note that there are discrepancies in the establishment of the evaluation requirements in respect of each component, which may exacerbate confusion in this area. Accordingly, we recommend that the IAASB establish equivalent evaluation requirements in respect of each of the components of the entity's system of internal control. Please refer to question 5(a) in the appendix for further details.

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As noted above, we welcome the differentiation introduced between the overarching requirements in paragraph 25 (which refer to "understanding" each of the components) and paragraph 26 (which refer to "evaluating the design and implementation" of "controls relevant to the audit"). However, paragraph 25 indicates that to "understand each of the components" of internal control the auditor would refer to paragraph 27 - 38. Paragraph 38 addresses the understanding of the control activities component, which is developed *by* identifying controls relevant to the audit and evaluating their design and implementation. As a result, this appears to contradict the intention to demarcate "understanding" and "evaluation of design and implementation of controls relevant to the audit", and instead blurs the distinction by co-mingling these two concepts, which gives rise to confusion.

We suggest that the IAASB clarify the standard by amending the reference at paragraph 25 to refer to paragraphs 27-37, with paragraph 38 being linked to paragraph 26, since it is addressing controls relevant to the audit. Furthermore, the IAASB could rephrase paragraph 38 to remove reference to "understanding" and to simply state that the auditor is to evaluate the design and implementation of controls relevant to the audit within the Control Activities component in accordance with paragraph 39.

Further to the above, paragraph 36 sets out a requirement to "evaluate the design of the information system controls relevant to financial reporting" (i.e. the controls within the Information System and Communication component that are relevant to financial reporting per the definition in 16(d)). This paragraph, once again, combines "understanding the component" with "evaluating the design and implementation of controls" and introduces more confusion to the issue that we believe the IAASB is trying to clarify, per the EM.

Accordingly, we believe that the IAASB needs to be explicit as to whether the "evaluation" at paragraph 36 is intended to be:

(i)   An "evaluation milestone" which is performed in respect of the Information System and Communication component, based on the understanding of this component, as a whole, obtained in accordance with paragraph 35, similar to the evaluation milestones for the Control Environment component, entity Risk Assessment Process component, and Process to Monitor the System of Internal Control component; or

(ii)   An incremental step involving more specific evaluation of the design and implementation of (direct) controls relevant to financial reporting within the Information System and Communication component. If this is the case, we recommend that the IAASB explicitly state this, and also explain how this

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would assist the auditor in identifying risks of material misstatement at the assertion level.

We note that various application paragraphs appear to support view (i) above, however, the flowchart and paragraph 35 of the EM appear to support view (ii). Additionally, it is unclear as to the nature of the "controls" that are to be evaluated in accordance with paragraph 36, including whether these are direct or indirect controls, and how these relate to the controls relevant to the audit that reside in the Control Activities component.

We are supportive of view (i) above, based on the descriptions in the application material of performing a walkthrough to understand the information flow, as we consider that improving the auditor's performance in obtaining an understanding of this overall "process" is an effective means to improve risk identification and assessment, and design a more appropriate audit response.

We would be concerned that view (ii) would involve identifying the controls that would be "relevant to financial reporting" in the Information System and Communication component and evaluating the design and implementation of these controls, which, as a corollary of the underlying interpretation of view (ii), would have a much broader reach than controls that are "relevant to the audit". We believe this may result in an auditor performing work that is not necessary as it is unclear how this would be helpful to an auditor to identify and assess risks of material misstatement. Although we recognise that the requirements set out in paragraph 35 make reference to the flow of information relating to significant classes of transactions, account balances and disclosures, which, may be intended to refer, via the concepts of relevant assertions and therefore potential material misstatements, to relevance to the audit, this is a rather circuitous route, and may give rise to confusion in practice. Additionally, since controls relevant to the audit are addressed at paragraphs 38/39 onwards, it would appear to be duplicative to require an auditor to evaluate the design and implementation of controls also as part of obtaining an understanding of this component. Furthermore, given the differences in terminology regarding "controls" used, as described below, and confusion as to which direct controls are in the Information System and Communication component versus which are in the Control Activities component, we believe this may lead to inconsistency in practice.

We believe much of the continued confusion in this area results from the use of "legacy" terminology. In particular, we believe the use of the word "control" in various contexts, without sufficient distinction between different "types" of "control", including, in certain instances, between "direct" and "indirect" controls, as well as the use of "control" when the intention may be to refer to a "process" as a whole, is not appropriate. Additionally, we believe there are certain instances of usage of "control" in a looser sense, to mean an "activity" that may not be a control as such. This makes it difficult for the auditor to understand the intention of, and comply with, the different requirements.

We also highlight that the similarity of the terminology "relevant to financial reporting" to "relevant to the audit" gives rise to confusion as it suggests an intentional symmetry between the requirements at paragraphs 36 and 42.

If the IAASB does intend paragraph 36 to be in line with view (i) above, then we believe the terminology of "relevant to financial reporting" is intended only to guide the auditor as to where a suitable boundary in relation to their understanding of the flow of information may lie, i.e. that this may be appropriately restricted to financial reporting matters and not wider business matters within the entity more generally. We therefore recommend that the IAASB consider revising/ further clarifying certain terms, including "relevant to financial reporting" used in the ED, as well as "controls" and "control activities", and furthermore, that the IAASB state explicitly that an auditor is not required to evaluate the design and implementation of controls, whether "indirect" or "direct" unless they are "relevant to the audit".

Understanding the IT Environment

In connection with the above, the requirement at 35(d) relating to the auditor's understanding of the IT environment, in particular, gives rise to scope for confusion. In conjunction with the definition of "IT environment" at 16(g), it may appear to indicate that the auditor is required to obtain an understanding of:

— All IT applications and IT infrastructures relevant to financial reporting (not just those relevant to the audit); and

— All the IT processes that manage program changes related to the above, that manage operations related to the above, and that monitor the above.

Accordingly, we recommend that the IAASB be explicit as to whether the understanding that is required to be obtained at paragraph 35(d) is intended to:

(i)   Involve "high-level understanding" to help identify IT applications that may be relevant to the audit, with the related evaluation required at paragraph 36 being intended to address considerations such as whether the IT environment is appropriate to the size and complexity of the entity (in line with view i) set out in the preceding section); or

(ii) Enable the auditor to identify risks arising from the use of IT, and GITCs. A144 states that the auditor is required to understand the IT environment relevant to the entity's information system *because* [emphasis added] the entity's use of IT applications or other aspects in the IT environment may give rise to risks arising from the use of IT.

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We highlight that the application material is again unclear in this area, partly because it again co-mingles the concepts of obtaining an "understanding" with evaluation of design and implementation of controls.

We recommend that the IAASB clarify its intentions as to the extent of understanding that is expected regarding the entity's IT environment, by including similar evaluation milestones to those at paragraphs 28 and 31, versus related requirements at paragraph 40, in particular, to set out explicitly when an auditor is required to identify risks arising from the entity's use of IT and whether this is only when IT applications and other aspects of the IT environment contain application controls relevant to the audit. Furthermore, we recommend that the IAASB distinguish between application material that relates to the understanding of the IT environment and application material that relates to the identification of IT applications and other aspects of the entity's IT environment that contain application controls that are relevant to the audit and the identification of related risks arising from the use of IT and GITCs.

We suggest that the application material explain more clearly how the understanding of the IT environment would help an auditor to identify and assess the risks of material misstatements, in circumstances where the IT applications and other aspects of the entity's IT environment do not contain application controls that are relevant to the audit.

Controls that are Relevant to the Audit

We are unclear as to the intended scope of the requirement at paragraph 39(e). As drafted, with reference to professional judgement, it may be intended to be a "catch all" to capture, in particular, "indirect" controls, such as when these may provide relevant information to identify fraud risk factors and identify assertion level fraud risks, and provide information related to matters such as management competence, which may help the auditor to assess inherent risks at the assertion level. However, the related application material appears to refer to controls that are "direct" in nature e.g. changes in the information system.

Additionally, we believe this requirement appears to contain circular logic since it requires auditors to evaluate the design and implementation of controls relevant to the audit, as determined appropriate by the auditor, in order to identify and assess risks of material misstatement at the assertion level or design further audit procedures responsive to assessed risks. However, since direct controls would be considered to be relevant to the audit *when* they address risks of material misstatement (at the assertion level), it would be challenging to comply with this requirement, without evaluating most/all direct controls, in order to make this determination. Furthermore, as a result of the circularity, it would be challenging for an auditor to determine when sufficient assessment has been performed. Therefore, we suggest that the IAASB clarify whether the requirement at paragraph 39(e) is intended to refer only to indirect controls, and, if so, to relocate this requirement accordingly, or to remove it completely.

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In light of the overarching objective to obtain sufficient appropriate audit evidence as the basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels, we recommend that the IAASB provide greater clarity as to how evaluation of the design and implementation of controls relevant to the audit assists an auditor in identifying and assessing risks of material misstatement. We recognise that the guidance, in particular at A200, sets out that this contributes to the auditor's understanding of the entity's system of internal control, however, we would welcome further clarity, and illustrative examples, in respect of both direct and indirect controls, as well as in respect of when the evaluation of the design and implementation of controls identifies control deficiencies. Since inherent risk is assessed without consideration of "direct" controls (controls relevant to the audit), and furthermore, if the auditor does not plan to test the operating effectiveness of such controls, and therefore control risk is established at maximum, the evaluation of design and implementation of direct controls does not impact on the control risk assessment. We understand the IAASB's intention to avoid situations in which auditors may place inadvertent reliance on controls and therefore this has implications for the further audit procedures that would not otherwise be performed. However, it is unclear how an auditor is to determine when it is appropriate to evaluate the design and implementation of direct controls for this purpose.

Appropriate Criteria for the Evaluation of Controls

The ED requires the auditor to evaluate the design and implementation of controls at various points, however, the application material does not provide guidance or attributes of suitable criteria as to how this evaluation is to be performed, other than reference to consideration as to whether the control is determined to meet the control objective established by management. We suggest the IAASB consider inclusion of similar material to the description of attributes of suitable criteria for assurance engagements, set out in ISAE 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*, such as whether criteria are relevant, complete, reliable, neutral and understandable, and whether their development has involved appropriate due process. Although we recognise that the ED is not intended to address an audit of internal control over financial reporting, we suggest that the IAASB consider providing an example of the COSO Framework, in particular, the concept of "present and functioning" (i.e. when applied to components of internal control, and related principles, "present" refers to the determination that components and relevant principles exist in the design and implementation of the system of internal control to achieve specified objectives, and "functioning" refers to the determination that components and relevant principles continue to exist in the conduct of the system of internal control to achieve specified objectives), as representing suitable criteria for making such an evaluation. The COSO Framework also addresses critical considerations in determining the attributes of a control that is suitably designed, including who at the entity is performing the control, whether they possess sufficient

competence, what the specific objective of the control is, how the control is to be executed and also refers to safeguards such as segregation of duties. In this regard, we highlight our earlier comments regarding differences from the COSO Framework, which is a clearly understood framework with a broad global usage, and suggest that the IAASB give further consideration to alignment, especially given that in other respects the IAASB appears to have sought to increase alignment.

Please contact Sheri Anderson at +44 (0)20 7694 8871 if you wish to discuss the contents of this letter.

Yours sincerely

KPMG IFRG Limited

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cc: Len Jui

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Appendix: Responses to Questions

1. **Has ED-315 been appropriately restructured, clarified and modernized in order to promote a more consistent and robust process for the identification and assessment of the risks of material misstatement. In particular:**

    (a) **Do the proposed changes help with the understandability of the risk identification and assessment process? Are the flowcharts helpful in understanding the flow of the standard (i.e. how the requirements interact and how they are iterative in nature)?**

    In general, we believe ED-315 has provided clarification regarding many aspects of the process for the identification and assessment of the risks of material misstatement, in comparison to the extant standard. We believe the flowcharts provide a helpful summary of the requirements and therefore we recommend that the flowcharts are ultimately included as part of the standard.

    We note that this is a highly complex standard, with much of this complexity residing in the fact that an auditor executes the required procedures in an iterative, or dynamic fashion. In considering the ED, much of our understanding of the amendments is informed by the EM, which provides helpful explanations regarding the Board's deliberations and the rationale for certain conclusions reached, as well as setting out more detail as to how certain requirements are intended to be applied. Accordingly, we suggest that much of this material be included in the final standard to support the aim of achieving consistent application of the standard.

    We note our concerns as to the understandability of certain aspects of the ED in our overarching comments, and in the responses to specific questions set out in this appendix. In particular, we consider that the standard would benefit from improved clarity in respect of the "understanding" obtained regarding each of the components of the entity's system of internal control, as we describe at question 5, and how this understanding helps the auditor to identify and assess the risks of material misstatement. Accordingly, we recommend that the IAASB provide more detailed application guidance in this area, with illustrative examples.

    In relation to the above, we also recommend that the IAASB clarify that an auditor is not required to evaluate the design and implementation of controls that are not considered to be relevant to the audit.

(b) Will the revisions promote a more robust process for the identification and assessment of the risks of material misstatement and do they appropriately address the public interest issues outlined in paragraphs 6-28?

We are supportive of the overall direction of the changes proposed to ISA 315 (Revised) and we believe that, in general, the changes are helpful in addressing the public interest issues identified.

In particular, we welcome the improvements and clarifications to the auditor's "understanding" of the entity's system of internal control as we consider that an improved understanding is critical to driving a more robust identification and assessment of the risks of material misstatement. We refer to our suggestions for further clarification in respect of the auditor's "understanding", as we describe in our overarching comments and also in our response to question 5.

In connection with this "understanding", we believe the increased emphasis on risk identification and assessment as a fundamental part of the audit, on which the auditor's responses are premised, through the inclusion at paragraph 17 of the requirement for the auditor "to obtain sufficient appropriate audit evidence as a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels", to be an important enhancement (although we note certain concerns with the terminology used, as we set out in our response to question 4). We believe this will help to establish a clearer link between the understanding of the entity's system of internal control obtained, the risks of material misstatement identified and assessed, and the auditor's responses, by requiring the auditor to specifically consider whether he/she has obtained sufficient understanding to identify and assess the risks of material misstatement at the financial statement and the assertion level. As a result, we believe this will support a more robust process for the identification and assessment of the risks of material misstatement, and drive greater consistency in performance.

We also consider the changes to the standard regarding the identification and assessment of the risks of material misstatement will help to drive a more robust risk assessment. In particular, we welcome the separate assessments of inherent and control risk at the assertion level, the introduction of the spectrum of inherent risk, the revised definition of significant risks, and the additional concepts of

significant classes of transactions, account balances and disclosures, and their relevant assertions. Please see our response to question 6 for further details.

With respect to the auditor's considerations relating to fraud, we are supportive of the enhancements made to ED-315 in this area, in particular, the addition of specific reference to ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, including reference in the introductory paragraphs.

However, we highlight that the references to fraud risks are dispersed throughout the ED, and this fragmentation may result in incomplete or inconsistent consideration of fraud risks. Therefore, we recommend that the IAASB consider clearer delineation of the requirements in respect of fraud risk between ISA 315 and ISA 240, with clarification that ISA 315 is intended to emphasise elements of ISA 240 that are applicable to risk identification and assessment, but that ISA 240 is required to be applied in its entirety.

(c) Are the new introductory paragraphs helpful?

We believe these are helpful to an auditor as they "set the scene"; help the auditor to navigate this complex standard, and give emphasis to key overarching concepts, including professional scepticism.

2. Are the requirements and application material of ED-315 sufficiently scalable, including the ability to apply ED-315 to the audits of entities with a wide range of sizes, complexities and circumstances?

We are supportive of the overall approach taken by the IAASB regarding scalability of the ED, i.e. the establishment of principles-based requirements, supported by illustrative application material, including guidance and examples as to how to apply the requirements across entities that vary significantly in terms of size and complexity.

We note that the EM, at paragraph 36, states that "clarifying the requirements related to the understanding of each component of the system of internal control is an important aspect of the proposed enhancements to the standard. Within each component, the IAASB has set out the matters that need to be understood, as well as providing further guidance about the extent and scalability of related procedures, as appropriate".

In connection with the above, we welcome, in particular the following enhancements:

— Acknowledgement that the nature, timing and extent of risk assessment procedures that the auditor performs to obtain the understanding of each component of the system of internal control are matters for the auditor's professional judgement and are based on the auditor's determination as to what will provide an appropriate basis for the identification and assessment of the risks of material misstatement;

— Recognition that aspects of the system of internal control may be less detailed/ formalised in smaller/ less complex entities;

— Clarification regarding understanding of the IT environment/identification of risks arising from IT and identification and evaluation of GITCs relevant to the audit at smaller/ less complex entities;

— Recognition that complexity as well as, or even more so than, size of an entity is important, as well as the complexity versus simplicity of the IT systems;

— The introduction of a spectrum of inherent risk, which, together with the inherent risk factors, we believe better allows for scalability. We also support the description of smaller AND less complex entities being at one extreme of the spectrum to help provide a reference point as to how the auditor would apply judgement (A224) and take into account the nature and circumstances of each entity.

Notwithstanding the above, we highlight elsewhere in our responses, in particular, in our response to question 5, suggestions for further, important improvements regarding the clarity of certain requirements, and we note that these apply to aspects of the standard that we believe are likely to present particular challenges to auditors in terms of whether and how these are to be applied in respect of audits of smaller/less complex entities.

It would be helpful if the IAASB could improve clarity in respect of these matters, as well as provide more specific examples as to the execution of these requirements. The application material contains highly generalised, theoretical guidance that the nature and extent of procedures may vary according to the audit circumstances, including the size and complexity of the entity subject to audit, but this material would benefit from more detailed, illustrative, examples. For example, improved clarity regarding the linkage between the understanding obtained in respect of the entity's control environment, risk assessment process and the process to monitor

the system of internal control and the identification and assessment of risks of material misstatement at the financial statement and assertion levels, particularly those that result from the financial reporting process, would be beneficial in promoting greater consistency in application of these requirements. It would be helpful if the IAASB were to provide greater clarity in this area, in particular, in respect of audits of smaller/ less complex entities for which a fully substantive audit is planned. Although A89-A103 provides considerations in respect of scalability, this is very general. We refer to the comments in the ICAEW publication, *Risk Assessment and Internal Controls: Continuing Challenges for Auditors.*

3. **Do respondents agree with the approach taken to enhancing ED-315 in relation to automated tools and techniques, including data analytics, through the use of examples to illustrate how these are used in an audit (see Appendix 1 for references to the relevant paragraphs in ED-315)? Are there other areas within ED-315 where further guidance is needed in relation to automated tools and techniques, and what is the nature of the necessary guidance?**

We agree with the approach taken and find the illustrative examples helpful. We believe this is appropriate in terms of the objective of modernising the standard and making it fit for purpose in today's technological environment.

We are supportive of the approach to avoid the use of terminology that is overly precise/narrow, or may be understood differently by various groups, as this is a rapidly developing field and we recognise the IAASB's intention not to outdate itself at the outset.

However, we suggest the IAASB further explore the impact of Data and Analytics (D&A) specifically on risk assessment, in terms of whether and how the nature and/or extent of the risk assessment procedures as currently described may change in an audit environment in which the auditor is able to incorporate information about all transactions, and at any point in the processing cycle, into its risk assessment process. If the IAASB includes further clarification, as we suggest in our overarching comments, as to the purpose of the "understanding" that is obtained in respect of each component, as well as the specific areas that are "evaluated", this will assist an auditor in determining whether D&A techniques may be applied as an integral part of risk identification and assessment, or may constitute the identification, assessment and the response concurrently. Paragraphs A33 and A213 touch on this but at a very high level. We recognise that

there is a discrete IAASB project to consider the implications of this on an audit. However, given the significant advances in technology and innovation that have fundamentally changed the way in which businesses operate, and the related considerations as to how the audit profession may harness technology to continually improve the audit process, it would be helpful to further acknowledge this area in the ED at least to pave the way for change or recognise the general direction of travel.

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

Overall we believe the proposals are helpful in supporting the appropriate exercise of professional scepticism throughout the risk identification and assessment process. In particular, we agree with the principles-based approach and reference to the concept of professional scepticism in an overarching fashion in the introductory paragraphs, rather than the inclusion of several, individually prescriptive requirements throughout the standard. We believe this approach is aligned to the current description of professional scepticism as being a mindset/ fundamental behaviour of an auditor.

With regard to the proposal to include a requirement in paragraph 17 for the auditor "to obtain sufficient appropriate audit evidence as a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels", we recognise the IAASB's intention to give greater emphasis to risk identification and assessment as a fundamental part of the audit, on which the auditor's responses are premised, and we agree this is an important enhancement, which will establish a clearer link between the understanding of the entity's system of internal control obtained, the risks of material misstatement identified and assessed, and the auditor's responses, by requiring the auditor to specifically consider whether he/she has obtained sufficient understanding to identify and assess the risks of material misstatement at the financial statement and the assertion level. An auditor will need to exercise professional scepticism in making this determination. In addition to driving a more robust approach from the auditor, we also believe this helps with scalability, as an auditor of a small/ less complex

entity should be able to determine that they have sufficient and appropriate understanding relatively quickly, and by performing fewer/ less comprehensive audit procedures.

Notwithstanding the above, we note that the terminology "sufficient appropriate audit evidence" is understood in a broader context and accordingly we believe this concept may cause confusion when applied to the separate "steps" in an individual ISA.

Accordingly, to avoid any potential confusion, we suggest that the IAASB may consider using alternative terminology to "evidence", such as "information", and also consider including a description of the risk assessment procedures such as "sufficiently thorough in order to provide a reasonable basis for …".

In addition, in light of the key objective of improving the application of professional scepticism during an audit, we recommend that the IAASB remove the "standback" requirement in ISA 330.18 as we believe that the placement of a requirement to validate, and even override, the risk assessment at a relatively advanced stage of the audit, as well as the specific language used, i.e. "irrespective of [the risk identification and assessment procedures performed]" may serve to reduce the emphasis on the risk identification and assessment process as a critical part of the audit process and, furthermore, may undermine the objective of the IAASB to underscore the importance of professional scepticism during this phase.

5. **Do the proposals made relating to the auditor's understanding of each component of the entity's system of internal control assist with understanding the nature and extent of the work effort required and the relationship of the work effort to the identification and assessment of the risks of material misstatement? Specifically:**

    (a) **Have the requirements related to the auditor's understanding of each component of the entity's system of internal control been appropriately enhanced and clarified? Is it clear why the understanding is obtained and how this informs the risk identification and assessment process?**

In connection with the objective of helping auditors to implement certain requirements of the standard in a more robust and consistent way, the EM notes, at paragraph 30, that significant concerns were highlighted relating to obtaining an

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understanding of the entity's system of internal control in the IAASB's outreach, including the need for additional clarity to address:

— Why the understanding is required to be obtained (e.g. when a primarily substantive approach to the audit is planned) and how the information obtained is to be used;

— What procedures are required in order to "obtain the necessary understanding" for certain components of internal control;

— Whether all components of internal control need to be understood; and

— When controls are considered "relevant to the audit".

We believe that clarifications regarding the above questions are critically important given the feedback the IAASB received during its outreach procedures, and furthermore, given concerns raised by regulators and national standard setters regarding implementation of the requirements of ISA 315 in this area, such as those described in the ICAEW publication*, Risk Assessment and Internal Controls: Continuing Challenges for Auditors* and the CPA Canada Implementation Tool: *Understanding the entity through internal control.*

We are therefore supportive, in general, of the proposed changes to address the above as we recognise that much of the complexity and scope for inconsistency of application of the requirements of the standard in practice lies in obtaining an "understanding" of the entity's system of internal control.

"Understanding" is a broad term and, as described in the application material, e.g. at A90 and A102, may be applied differently by auditors depending on the nature of each component of the entity's system of internal control, as well as factors that are specific to the entity, including its size, complexity, IT environment, and previous experience of the auditor with the entity, amongst others. We find the references to the auditor's use of professional judgement in designing and performing risk assessment procedures to obtain the required understanding to be helpful, and furthermore, we particularly welcome the improved distinction between an entity's system of internal control, the components within that system of internal control and the controls within each of these components as well as the improved specificity of requirements pertaining to each of these elements.

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We welcome the sequence in which the components of the system of internal control are presented, to include those that consist primarily of "indirect" controls first, followed by those that consist primarily of "direct" controls. This differentiation, together with related "evaluation" requirements in respect of each component, which more specifically explain which aspects of each component an auditor is to understand, is expected to help clarify how the understanding of each component will assist the auditor in identifying and assessing the risks of material misstatement.

We also welcome the clearer delineation between "understanding each of the components of internal control", as set out at paragraph 25 and "identifying the controls [within those components that are] relevant to the audit" and "evaluating the design and implementation of such controls" as set out at paragraph 26. This distinction more clearly articulates that an auditor is required to develop an understanding of the components of internal control for every audit, whether or not controls relevant to the audit have been identified, or are expected to be identified, and irrespective of whether an auditor plans to perform tests of operating effectiveness over such controls.

We consider that the inclusion of requirements to "understand" each component of internal control by reference to making specific "evaluations", as set out in the ED represents a significant enhancement. These evaluations provide greater focus on the specific matters that the auditor is to understand, with a number of "milestones", e.g. paragraph 28, which states that the auditor shall "evaluate whether the strengths in those areas of the control environment addressed in paragraphs 27(a) to (e) collectively provide an appropriate foundation for the other components of the system of internal control." In describing the objectives of the understanding, ED-315 helps auditors to determine what to understand for each component and therefore how to do this.

However, we do have a number of significant concerns relating to certain aspects of the "understanding" section of the ED, which we believe may continue to give rise to confusion and inconsistency in application. These aspects are described below and we suggest the IAASB explore our suggestions for further clarity, with a view to providing enhancements to help support their stated objectives.

Control Activities Component

We note that the Control Activities component does not appear to be a discrete component of an entity's system of internal control in the way that the other four components are. This may give rise to confusion, in particular, because the IAASB does not set out differentiated requirements to first "understand" this component and make a specific" evaluation" based on that understanding, and then to identify controls that are relevant to the audit and to evaluate their design and implementation. Instead, the IAASB describes that the understanding of this component is obtained *by* identifying controls in the component that are relevant to the audit and evaluating the design and implementation of these controls.

As a result, "control activities" and "[direct] controls" (in the Control Activities component) seem to have the same meaning. We suggest therefore that the IAASB select a single, appropriate term and apply this consistently. If the IAASB intends there to be a difference between the terms, we recommend that the IAASB explicitly clarify this difference.

Distinction Between Controls Within the Control Activities Component and Information System Controls Relevant to Financial Reporting

As a result of the above, there is a lack of clarity as to how "controls" in the Control Activities component are distinct from "controls" in the other components, in particular, those in the Information System and Communication component. The ED notes, e.g. at A101, that "direct" controls, which are controls that are designed to prevent, or detect and correct, misstatements at the assertion level, reside mainly in the Information System and Communication component, as well as the Control Activities component. For example, controls within the information system relevant to financial reporting relating to how the entity "corrects as necessary" the transactions (paragraph 35(a)(i)) may often be the controls within the Control Activities component that the auditor plans to test as to whether they are operating effectively (paragraph 39(d)).

The EM, paragraph 35, and application material at A157 and A166, appear to differentiate between the controls in each component by explaining that the controls (policies and procedures) in the Information System and Communication component, that define the nature, timing and extent of the entity's financial reporting processes, and how the entity's personnel, IT and other resources are deployed in applying them, are information system controls relevant to financial reporting, whereas controls in the Control Activities component are controls *over* the flows of information and the financial reporting processes, and that it is these controls that primarily comprise the "controls that are relevant to the audit", for

which an auditor is required to evaluate the design and implementation. Furthermore, paragraph A 157 states that "controls over information systems are treated as controls in the Control Activities component and may be identified as controls relevant to the audit". A166 states that "controls relevant to the audit are primarily direct controls and are primarily controls in the Control Activities component because such controls typically are controls over the entity's information system and address risks of material misstatement at the assertion level".

However, we do not consider that this sufficiently clarifies the distinction, and furthermore, we note that paragraph 35 of the EM introduces confusion by stating that "Information System and Communication, and Control Activities components are comprised primarily of controls that directly address the risks of material misstatement at the assertion level". We therefore recommend that the IAASB further describe the intended inter-relationship between these two components, and the boundary, if any, between the types of controls that reside within each.

We also note that the description of the Control Activities component is different from that set out in the COSO Framework in that within the COSO Framework, this component is clearly defined, with the inclusion of related, established principles, and descriptions as to how this component interrelates with, or supports the other components of the system of internal control.

Although we note that the COSO Framework is designed for use in an integrated audit, we highlight that these differences from the COSO Framework, which is a clearly understood framework with a broad global usage, may create confusion, especially given that in other respects the IAASB appears to have sought to increase alignment of key aspects of ISA 315 with the COSO Framework.

Scope for Inconsistent Application of Requirements Regarding Obtaining the "Understanding"

We appreciate that the ED is attempting to make a distinction between components of internal control that contain primarily direct versus primarily indirect controls and consequently the work effort required by the auditor for each of these components in order to appropriately identify and assess risks and develop the appropriate responses. Our interpretation of the requirements is that the auditor is required to obtain an understanding of the Control Environment, the entity's Risk Assessment Process, the entity's Process to Monitor the System of Internal Control, and the Information System and Communication components of the entity's system of internal control by performing the procedures set out in the standard but that this understanding does not involve identifying controls, and nor

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does it involve evaluating the design and implementation of such controls within these components at this point. The auditor is required to identify controls that are relevant to the audit and to evaluate the design and implementation of such controls, at paragraph 39 onwards, based on the understanding obtained.

It would be helpful if the IAASB were to explicitly state this, in order to drive consistency in application of the requirements of the standard in this area, which is one of the IAASB's stated objectives. In particular, we note that there is scope for confusion and inconsistent application of the requirements in respect of the Information System and Communication component, as we set out below. Additionally, we note that there are discrepancies in the establishment of the evaluation requirements in respect of each component, as we describe below, which may exacerbate confusion in this area. Accordingly, we recommend that the IAASB establish equivalent evaluation requirements in respect of each of the components of the entity's system of internal control.

As noted above, we welcome the differentiation introduced between the overarching requirements in paragraph 25 (which refer to "understanding" each of the components) and paragraph 26 (which refer to "evaluating the design and implementation" of "controls relevant to the audit"). However, paragraph 25 indicates that to "understand each of the components" of internal control the auditor would refer to paragraphs 27-38. Paragraph 38 addresses the understanding of the control activities component, which is developed *by* identifying controls relevant to the audit and evaluating their design and implementation. As a result, this appears to contradict the intention to demarcate "understanding" and "evaluation of design and implementation of controls relevant to the audit", and instead blurs the distinction by co-mingling these two concepts, which gives rise to confusion.

We suggest that the IAASB clarify the standard by amending the reference at paragraph 25 to refer to paragraphs 27-37, with paragraph 38 being linked to paragraph 26, since it is addressing controls relevant to the audit. Furthermore, the IAASB could rephrase paragraph 38 to remove reference to "understanding" and to simply state that the auditor is to evaluate the design and implementation of controls relevant to the audit within the control activities component in accordance with paragraph 39.

Further to the above, paragraph 36 sets out a requirement to "evaluate the design of the information system controls relevant to financial reporting" (that is, the controls within the Information System and Communication component that are relevant to financial reporting per the definition in 16(d)). This paragraph, once again, co-mingles "understanding the component" with "evaluating the design and

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implementation of controls" and introduces more confusion to the issue that we believe the IAASB was trying to clarify per the EM.

Accordingly, we believe that the IAASB needs to be explicit as to whether the "evaluation" at paragraph 36 is intended to be:

(i) An "evaluation" milestone which is performed in respect of the Information System and Communication component, based on the understanding of this component, as a whole, obtained in accordance with paragraph 35, similar to the evaluation milestones for the Control Environment component, entity Risk Assessment component, and Process to Monitor component. A154 seems to suggest this as it states that "the audit evidence obtained by these risk assessment procedures [at paragraph 35] is used by the auditor to evaluate the design of the information system controls relevant to financial reporting and determine whether they have been implemented." If this is the case, we recommend that the IAASB clarify this, by prefacing the requirement with similar language to the other evaluation milestones such as "based on the understanding obtained…… in accordance with paragraph 35", and also by stating more clearly in the application material that the auditor is not required to evaluate the design and implementation of controls other than those that are identified as relevant to the audit in accordance with paragraphs 39-41; or

(ii) An incremental step involving more specific evaluation of the design and implementation of (direct) controls relevant to financial reporting within the Information System and Communication component. If this is the case, we recommend that the IAASB explicitly state this, and also explain how this would assist the auditor in identifying risks of material misstatement at the assertion level.

We believe paragraphs A166 and A157 appear to support view i) above. In describing the understanding of the information system relevant to financial reporting, we believe the IAASB intends this to mean a "higher-level" understanding of the process overall, such as may be obtained by performing a "walkthrough", with an overall evaluation performed of the design and implementation of this "process" as a whole, focusing on information flow. This would help to ensure that an auditor develops an appropriate understanding of the flow of information through an entity, including the use of the entity's IT environment, and through this understanding the auditor is able to design further audit procedures and avoid inadvertent reliance on controls. A200 appears to describe this. A157 states that the auditor may perform a walk-through of a transaction to confirm the flow of transactions relevant to the transaction. A157

further states that at the same time, the auditor may evaluate the design and implementation of controls relevant to the audit that relate to that class of transactions (i.e. over the flow) such as those related to approvals or reconciliations. We believe the IAASB is referring to the iterative nature of the audit here and therefore this is why the concepts of understanding a component and evaluation of design and implementation of controls are co-mingled, but that the IAASB's intention is to differentiate these requirements.

We are supportive of view (i) based on the above, as we consider that improving the auditor's performance in obtaining an understanding of this overall "process" is an effective means to improve risk identification and assessment, and design a more appropriate audit response.

However, we note that the flowchart, and paragraph 35 of the EM, appear to support view (ii). In particular, because they seem to equate evaluating the design and implementation of the controls within the Information System and Communication component to evaluating the design and implementation of controls relevant to the audit. Additionally, it is unclear as to the nature of the "controls" that are to be evaluated in accordance with paragraph 36, including whether these are "direct" or "indirect" controls, and how these relate to the controls relevant to the audit that reside in the Control Activities component.

If the IAASB intends paragraph 36 to be in line with view (ii) above, we would be concerned that view (ii) would involve identifying the controls that would be "relevant to financial reporting" in the Information System and Communication component and evaluating the design and implementation of these controls, which, as a corollary of the underlying interpretation of view (ii), would have a much broader reach than controls that are "relevant to the audit". We believe this may result in an auditor performing work that is not necessary as it is unclear how this would be helpful to an auditor to identify and assess risks of material misstatements. Although we acknowledge that it could help the auditor to design the audit response, we do not believe it is necessary to evaluate the design and implementation of all controls relevant to financial reporting to design an appropriate audit response.

Although we recognise that the requirements set out in paragraph 35 make reference to the flow of information relating to significant classes of transactions, account balances and disclosures, which, may be intended to refer, via the concepts of relevant assertions and therefore potential material misstatements, to relevance to the audit, this is a rather circuitous route, and may give rise to confusion in practice. Additionally, since controls relevant to the audit are addressed at paragraphs 38/39 onwards, it would appear to be duplicative to

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require an auditor to evaluate the design and implementation of controls also as part of obtaining an understanding of this component. Furthermore, given the differences in terminology regarding "controls" used, as described below, and confusion as to which direct controls are in the Information Systems and Communication component versus which are in the Control Activities component, we believe this may lead to inconsistency in practice.

We believe much of the continued confusion in this area results from the use of "legacy" terminology. In particular, we believe the use of the word "control" in various contexts, without sufficient distinction between different "types" of control, including, in certain instances, between "direct" and "indirect" controls, as well as the use of "control" when the intention may be to refer to a process as a whole, is not appropriate. Additionally, we believe there are certain instances of usage of "control" in a looser sense, to mean an "activity" that may not be a control as such. This makes it difficult for the auditor to understand the intention of, and comply with, the different requirements. We also highlight that the similarity of the terminology "relevant to financial reporting" to "relevant to the audit" also gives rise to confusion as it suggests an intentional symmetry between the requirements at paragraphs 36 and 42.

If the IAASB does intend paragraph 36 to be in line with view (i) above, then we believe the terminology of "relevant to financial reporting" is intended only to guide the auditor as to where a suitable boundary in relation to their understanding of the flow of information may lie, i.e. that this may be appropriately restricted to financial reporting matters and not wider business matters within the entity more generally. We therefore recommend the IAASB consider revising/further clarifying certain terms, including "relevant to financial reporting" used in the ED, as well as "controls" and "control activities" and, furthermore, that the IAASB state explicitly that an auditor is not required to evaluate the design and implementation of controls, whether "indirect" or "direct" unless they are "relevant to the audit".

Use of Terminology "to Evaluate"

In connection with the above, we note that there is inconsistency and lack of clarity in inclusion of the "evaluation" step, such as:

— Paragraph 24 focuses on the auditor's evaluation of the appropriateness of the entity's accounting policies, following the requirement to understand the financial reporting framework at paragraph 23(b), which results in a lack of clarity as to why the auditor needs to understand the entity and its environment as required by paragraph 23(a), other than by reference to the overarching objective set out at paragraph 17;

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— The process to monitor the system of internal control does not have a corresponding evaluation requirement;

— In some cases the focus of the evaluation requirement appears too narrow, e.g. at paragraph 24 to "evaluate whether the entity's accounting policies, and any changes thereto, are appropriate… and consistent". Whilst we agree that this is an important consideration, we believe that the understanding of the applicable financial reporting framework would go beyond this to involve, as required at 23(b) (i), how it applies in the nature and circumstances of the entity and its environment, including how events or conditions are subject to, or affected by, the inherent risk factors. Such matters would assist the auditor in forming an initial view of risks of material misstatement such as identifying areas of subjectivity/ complexity, susceptibility to misstatement due to management bias or fraud, or matters involving estimates and/or significant assumptions and judgements;

— We have particular concerns regarding the description of the requirement at paragraph 36 to evaluate the design and implementation of the information system controls relevant to financial reporting, as we describe above.

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

This is a complex area, and auditors need a clear framework to underpin their use of professional judgement. We therefore highlight the following areas where we believe there is a lack of clarity:

— We are unclear as to the intended scope of the requirement at paragraph 39(e). As drafted, with reference to professional judgement, it may be intended to be a "catch all" to capture, in particular, "indirect" controls, such as when these may provide relevant information to identify fraud risk factors and identify assertion level fraud risks, and provide information related to matters such as management competence, which may help the auditor to assess inherent risks at the assertion level. However, the application material at A179 appears to refer to controls that are "direct" in nature e.g. changes in the information system.

Additionally, we believe this requirement appears to contain circular logic since it requires auditors to evaluate the design and implementation of controls

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relevant to the audit, as determined appropriate by the auditor, in order to identify and assess risks of material misstatement at the assertion level or design further audit procedures responsive to assessed risks. However, since direct controls would be considered to be relevant to the audit *when* they address risks of material misstatement (at the assertion level), it would be challenging to comply with this requirement, without evaluating most/ all direct controls, in order to make this determination. Furthermore, as a result of the circularity, it would be challenging for an auditor to determine when sufficient assessment has been performed. Therefore, we suggest that the IAASB clarify whether the requirement at paragraph 39(e) is intended to refer only to indirect controls, and, if so, to relocate this requirement accordingly, or to remove it completely.

— In light of the overarching objective to obtain sufficient appropriate audit evidence as the basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels, we recommend that the IAASB provide greater clarity as to how evaluation of the design and implementation of direct controls (control relevant to the audit) assists an auditor in identifying and assessing risks of material misstatement at the assertion level. We recognise that the guidance, in particular at A200, sets out that this contributes to the auditor's understanding of the entity's system of internal control, however, we would welcome further clarity, and illustrative examples, in respect of both direct and indirect controls, as well as in respect of when the evaluation of the design and implementation of controls identifies control deficiencies. Since inherent risk is assessed without consideration of "direct" controls (controls relevant to the audit), and furthermore, if the auditor does not plan to test the operating effectiveness of such controls, and therefore control risk is established at maximum, the evaluation of design and implementation of direct controls does not impact on the control risk assessment. We understand the IAASB's intention to avoid situations in which auditors may place inadvertent reliance on controls and therefore this has implications for the further audit procedures that would not otherwise be performed. However, it is unclear how an auditor is to determine when it is appropriate to evaluate the design and implementation of direct controls for this purpose.

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Also, the related application material at A179 states that the evaluation of the design and implementation of these controls contributes to the audit evidence related to risks of material misstatement that are assessed as higher, but not significant on the spectrum of inherent risk. We note further that A179 states that similar to controls over significant risks, the auditor's evaluation of the design of these controls and determination of whether they have been implemented contributes to the audit evidence related to that higher risk. It is unclear how performance of procedures to evaluate the design and implementation of these controls would assist an auditor in identifying and assessing risks of material misstatement at the assertion level. It would be helpful if the IAASB were to clarify whether their intention is to suggest that this may provide audit evidence for inherent risk assessment, and if this is the case, to provide an illustrative example, or whether the intention is to suggest that this would help an auditor to make a preliminary assessment of control risk when considering whether it would be appropriate to test operating effectiveness.

— Paragraph A180 is not clear as to when, for example, IT applications relevant to financial reporting are relevant to the audit because it is defined in the application material as the IT applications for the purpose of financial reporting on which management is relying as opposed to when the auditor is relying on controls within those IT applications to modify the nature, timing and extent of substantive procedures. We believe this may give rise to confusion and we consider that IT applications relevant to the audit should be the IT environment that includes application controls that are relevant to the audit.

— We do not believe the standard is sufficiently clear that risks arising from IT should be able to be tested substantively by an auditor, and it is not always required to test the GITCs that address these risks.

— In connection with our comments earlier regarding what constitutes a "relevant" control, we believe that the current definition may result in inference by auditors that this equates to whenever a risk of material misstatement has been identified. We suggest that the IAASB provide clarification, and if this is the intended meaning, we recommend the IAASB explore further as to whether this is appropriate, given the expected impact on the audit.

— We also highlight that the requirement at paragraph 39(c) in relation to controls over journal entries, including non-standard journal entries is unclear. In order

to improve consistency of application it would be helpful for the IAASB to provide guidance on the application of design and implementation for journal entries that are almost always/ often dependent on controls for the underlying data and transactions including how this requirement may relate to automated controls. We recognise that the extant standard contains an equivalent requirement, however, we recommend that the IAASB consider their intention behind the extant requirement and explore whether it is appropriate to retain this in the ED, given the significant evolution in the use of IT by businesses in recent years, with the result that many journal entries are processed automatically, and are reliant on other controls for completeness and accuracy.

Appropriate Criteria for the Evaluation of Controls

In addition to the above, the ED requires the auditor to evaluate the design and implementation of controls at various points, however, the application material does not provide guidance or criteria as to how this evaluation is to be performed, other than reference to consideration as to whether the control is determined to meet the control objective established by management. We suggest the IAASB consider inclusion of similar material to the description of attributes of suitable criteria for assurance engagements, set out in ISAE 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*, such as whether criteria are relevant, complete, reliable, neutral and understandable, and whether their development has involved appropriate due process. Although we recognise that the ED is not intended to address an audit of internal control over financial reporting, we suggest that the IAASB consider guidance in the COSO Framework, in particular, the concept of "present and functioning" (i.e. when applied to components of internal control, and related principles, "present" refers to the determination that components and relevant principles exist in the design and implementation of the system of internal control to achieve specified objectives, and "functioning" refers to the determination that components and relevant principles continue to exist in the conduct of the system of internal control to achieve specified objectives), as representing suitable criteria for making such an evaluation.

The COSO Framework also addresses critical considerations, in determining the attributes of a control that is suitably designed, including who at the entity is performing the control, whether they possess sufficient competence, what the specific objective of the control is, how the control is to be executed and

also refers to safeguards such as segregation of duties. In this regard, we highlight our earlier comments regarding differences from the COSO Framework, which is a clearly understood framework with a broad global usage, and suggest that the IAASB give further consideration to alignment, especially given that in other respects the IAASB appears to have sought to increase alignment.

(c) Do you support the introduction of the new IT-related concepts and definitions? Are the enhanced requirements and application material related to the auditor's understanding of the IT environment, the identification of the risks arising from IT and the identification of general IT controls sufficient to support the auditor's consideration of the effects of the entity's use of IT on the identification and assessment of the risks of material misstatement?

We support the introduction of the new IT-related concepts and definitions and agree that these are necessary to ensure that ISA 315 remains fit for purpose in a modern environment.

In connection with the above concerns regarding the understanding to be obtained in respect of the information system and communication component and the evaluation of the design and implementation of controls relevant to financial reporting within this component, the requirement at 35(d) relating to the auditor's understanding of the IT environment, in particular, gives rise to scope for confusion. In conjunction with the definition of "IT environment" at 16(g), it may appear to indicate that the auditor is required to obtain an understanding of:

— All IT applications and IT infrastructure relevant to financial reporting (not just those relevant to the audit);

— All the IT processes that manage program changes related to the above, that manage operations related to the above, and that monitor the above.

Accordingly, we recommend that the IAASB be explicit as to whether the understanding that is required to be obtained at paragraph 35(d) is intended to:

(i) Involve "high-level understanding" to help identify IT applications that may be relevant to the audit, as suggested by A180, with the evaluation required at paragraph 36 being intended to address considerations such as whether the IT

environment is appropriate to the size and complexity of the entity (in line with view i) set out in the preceding section).

This appears to be described in A151-7. Paragraphs 40- 41 appear to support this as they require that risks arising from IT and GITCs that are relevant to the audit are identified for the IT applications, IT infrastructures, and IT processes that are relevant to the audit, and that such identification is "based on" the understanding obtained in accordance with paragraph 35(d) and the identification of controls relevant to the audit in accordance with paragraph 39. Furthermore, paragraph 42 only requires the design and implementation of these controls when they are relevant to the audit.

Paragraph 44 of the EM states that the IAASB is of the view that it is not necessary for the auditor to identify risks arising from the entity's use of IT or GITCs unless there are IT applications that are determined to be relevant to the audit in accordance with the criteria set out at paragraph 40 of the ED. It would be helpful if the IAASB were to explicitly state this in the ED itself; or

(ii) Enable the auditor to identify risks arising from the use of IT, and GITCs. A144 states that the auditor is required to understand the IT environment relevant to the entity's information system *because* [emphasis added] the entity's use of IT applications or other aspects in the IT environment may give rise to risks arising from the use of IT.

We highlight that the application material is again unclear in this area, partly because it again co-mingles the concepts of obtaining an "understanding" with evaluation of design and implementation of controls.

We recommend that the IAASB clarify its intentions as to the extent of understanding that is expected regarding the entity's IT environment, by including similar evaluation milestones to those at paragraphs 28 and 31, versus related requirements at paragraph 40, in particular, to set out explicitly when an auditor is required to identify risks arising from IT and whether this is only when IT applications and other aspects of the IT environment contain application controls relevant to the audit. Furthermore, we recommend that the IAASB distinguish between application material that relates to the understanding of the IT environment and application material that relates to the identification of IT applications and other aspects of the entity's IT environment that contain application controls that are relevant to the audit and the identification of related risks arising from the use of IT and GITCs.

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We suggest that the application material explain more clearly how the understanding of the IT environment would help an auditor to identify and assess the risks of material misstatements, in circumstances where the IT applications and other aspects of the entity's IT environment do not contain application controls that are relevant to the audit. We also suggest that the IAASB clarify what is meant by a "high level understanding of IT processes and personnel", as set out in A147.

We also highlight the following concerns with certain definitions:

— Application controls now appear to be defined as all controls (in the entity's information system) not just controls within an application. We question whether this change is necessary as it may cause confusion;

— The definition of application controls states that "such controls may rely on information, or other controls that maintain the integrity of information, or may rely on the operation of other controls". We suggest that the IAASB clarify their intention here such as by providing an illustrative example.

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

In connection with the identification of risks of misstatement, we suggest that the IAASB provide clearer linkage between the risk assessment procedures performed, including the "understanding" required by paragraphs 23-25, and the identification of risks of material misstatement, at paragraph 45. Application material at A201-210 provides very high level guidance, and makes reference to the iterative nature of the audit, and furthermore, the distinction between identifying risks of material misstatement and assessing these becomes blurred. We recommend that the IAASB provide further guidance in this area.

(a) **Do you support separate assessments of inherent and control risk at the assertion level, and are the revised requirements and guidance appropriate to support the separate assessments?**

We support this change and we consider that the related requirements and guidance are generally clear. We believe this amendment results in better alignment to ISA 330.7, which requires the auditor to consider inherent risk and

control risk separately in order to respond, and it also aligns to the amendments already made to ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* in this regard. We agree with the statement in the EM that the separation of these assessments helps to avoid auditors subconsciously "taking credit" for testing effectiveness of controls when they have not or do not plan to perform such procedures.

We note that there is a lack of clarity at paragraphs 3 and 48, when describing, under risks of material misstatement at the assertion level, that inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls, regarding whether such aggregation of misstatements is intended to mean misstatements resulting from the same underlying risk, or from multiple risks. Clarification of this is important for auditors as it affects whether auditors need to consider risks of misstatement individually for each assertion, with aggregation referring only to misstatements related to that particular risk, or whether auditors consider risks of misstatement that in the aggregate may cause a material misstatement in an assertion, which may involve multiple risks of misstatement that individually may not represent a risk of material misstatement but in combination with others may give rise to a material misstatement. We believe the latter interpretation, i.e. that the aggregation of misstatements is intended to mean misstatements resulting from multiple risks, is appropriate, and accordingly, we suggest that the IAASB state this.

In addition, we note that, in separating the inherent risk and control risk assessments, the standard does not explicitly require the auditor to consider the combination of inherent risk and control risk in order to assess the risk of material misstatement at the assertion level. Paragraph 7, in the introduction, refers to this, however, given the flow of requirements at paragraphs 45-50, this appears to be an omission, and we recommend including this specific requirement immediately after paragraph 49, as well as including guidance in the application material as to how to make a combined assessment.

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

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We support the introduction of the concepts and definitions of "inherent risk factors" as we consider these help the auditor to focus on particular areas of susceptibility to risk of material misstatement and help the auditor to consider "pure" inherent risk, which is aligned to the separation of the assessment of inherent risk and control risk.

We believe that consideration of these factors provides a clear link to the understanding that the auditor has developed regarding the entity and its environment, and the system of internal control. The factors are very useful in helping the auditor to determine where on the spectrum of inherent risk a particular risk lies.

(c) In your view, will the introduction of the "spectrum of inherent risk" (and the related concepts of assessing the likelihood of occurrence, and magnitude, of a possible misstatement) assist in achieving greater consistency in the identification and assessment of the risks of material misstatement, including significant risks?

We are supportive of the introduction of the spectrum of inherent risk and we believe this aligns well with the other changes made in the ED to focus the auditor more specifically on consideration of "pure" inherent risk, and helps us to understand that this may vary continuously, rather than being the binary assessment of significant versus non-significant that we make at present.

Together with the updated definition of significant risk, the concept of a spectrum helps the auditor to focus on the nature of the risks themselves, rather than requiring a determination as to whether a risk is significant based on the expected audit response, i.e. whether the risk requires "special audit consideration".

We recognise that the IAASB has considered whether to retain the concept of significant risk, rather than creating an approach that guides the auditor to assess where on the spectrum of risk a matter lies and then to design a response accordingly, using professional judgement. We support the IAASB's conclusion to retain the concept on the basis that other ISAs contain the concept of significant risk.

Furthermore, we do believe that some sort of "threshold" is needed in order to provide auditors with a clear framework to assess the severity of risks, and to

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trigger certain audit responses on a consistent basis, with this threshold being that a risk is assessed as significant.

In relation to this, we have concerns regarding the IAASB's preliminary conclusion that significant risks are best represented by a high likelihood of occurrence OR high magnitude of potential misstatement, rather than AND, and the auditor will apply their professional judgement as to whether a matter is actually a significant risk. We recognise the IAASB's intention not to explicitly exclude risks that may potentially be relatively low in likelihood but for which the magnitude could be very high if the risk were to crystallise. Furthermore, we acknowledge the IAASB's objective to promote careful consideration of matters such as fraud, compliance with laws and regulations, including regulations around money laundering, bribery and corruption, as well as consideration of the outcome of potential litigation, which may have a very high magnitude and for which sufficient appropriate audit evidence is needed in order to properly assess the likelihood of occurrence.

However, we are concerned that, as drafted, the ED appears to suggest that significant risks may be represented by matters that have a high magnitude, but a low likelihood (i.e. exceeding the threshold of more than remote), which would result in an audit response that includes increased focus on these matters. We highlight that fraud considerations are addressed elsewhere, including within the inherent factors in the ED, as well as by the specific requirements of ISA 240. We also believe that in respect of other areas such as litigation and claims, and compliance with laws and regulation, there may be inherent uncertainty as to the "likelihood" of a material misstatement arising in respect of such matters, which necessarily results in increased auditor focus. However, if an auditor is able to determine that there is a low likelihood of such a matter resulting in a material misstatement, then we do not believe it to be appropriate to require that such a matter be treated as a significant risk. As a result of the above, we recommend that the IAASB amend the ED to refer to a high likelihood of occurrence AND high magnitude of potential misstatement.

(d) Do you support the introduction of the new concepts and related definitions of significant classes of transactions, account balances and disclosures, and their relevant assertions? Is there sufficient guidance to explain how they are determined (i.e., an assertion is relevant when there is a reasonable possibility of occurrence of a misstatement that is material with respect to that assertion), and how they assist the auditor in identifying where risks of material misstatement exist?

We are supportive of inclusion of these new concepts and definitions and their clear links with relevant assertions. We believe this aligns better to other standards e.g. ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing*, and helps the auditor to identify where risks of material misstatement exist by establishing clearer "steps" in this overall process as well as emphasising the iterative nature of these steps.

We recommend that the IAASB provide further information to support the definitions, such as examples of "classes of transactions" and "account balances" and the distinction between the two, as well as information to help an auditor distinguish between "transactions" and "classes of transactions", as the standard refers to both these terms, e.g. at paragraph 35(a).

We highlight that there is some inconsistency in the use of "classes of transactions" versus "transactions". For example, at A204(a) we believe the reference should be to "Assertions about ~~classes of~~ transactions and events, and related disclosures…". We note that the remainder of A204 refers only to "transactions".

We note that the definition of relevant assertions at paragraph 16(h) appears to equate "reasonable possibility of occurrence" with a "more than remote likelihood". We question whether it is appropriate to interchange this terminology, and recommend that the IAASB use "reasonable possibility".

(e) Do you support the revised definition, and related material, on the determination of "significant risks"? What are your views on the matters presented in paragraph 57 of the Explanatory Memorandum relating to how significant risks are determined on the spectrum of inherent risk?

We support revisions to the definition that better focus on a significant risk being close to the upper end of the spectrum of inherent risk, rather than on the response

to the risk alone. It allows for greater judgement of the auditor, and better enables compliance with the requirement (in the extant standard at paragraph 27) to identify significant risks excluding the effects of controls, i.e. based on the inherent risk alone.

In terms of the description of the spectrum of inherent risk, and how significant risks are represented on the spectrum, we refer to our response to question 6(c), above.

7. **Do you support the additional guidance in relation to the auditor's assessment of risks of material misstatement at the financial statement level, including the determination about how, and the degree to which, such risks may affect the assessment of risks at the assertion level?**

We consider that the additional guidance better clarifies that when risks affect a number of assertions, the risks have a more pervasive effect on the financial statements and therefore this needs to be assessed to develop overall responses, as well as to consider how such risks affect the assessment of risks of material misstatement at the assertion level. We also support the focus on, and clearer linkage between, control deficiencies identified in the system of internal control and the implications for the audit in terms of designing and implementing overall responses.

8. **What are your views about the proposed stand-back requirement in paragraph 52 of ED-315 and the revisions made to paragraph 18 of ISA 330 and its supporting application material? Should either or both requirements be retained? Why or why not?**

We do not necessarily believe that it is critical that ISA 315 should include a standback requirement, since there is greater emphasis now on the iterative nature of the risk assessment process, as well as the increased clarity in respect of how and why to perform each step, and furthermore the emphasis on professional scepticism.

However, given the complexity of the standard and the fact that many of the steps are performed concurrently, which necessitates the auditor continually updating their understanding and re-considering their initial views formed and assessments made, we believe that overall it may be helpful to have a standback at the end of the ISA 315 risk assessment process, before the auditor proceeds to the execution

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of responses. This also flows well into paragraph 53 which reminds auditors that the assessments of risk may change as additional evidence is obtained.

We recommend that the IAASB include further guidance in the application material as to the matters the auditor would be expected to consider in performing this requirement, such as performing a re-evaluation of any relevant inherent risk factors for these non-significant classes of transactions, account balances and disclosures.

However, we do not support the inclusion of "qualitatively" when describing how an item may be identified as being material in paragraph 52. We believe that the enhancements to ED-ISA 315 should drive an auditor to perform appropriately robust risk identification and assessment procedures, including identification of significant risks, which includes focus on inherent risk factors that are qualitative. Accordingly, inclusion of the concept of "qualitatively material" within the standback paragraph may cause confusion or serve to undermine the auditor's determination that they have performed sufficient and appropriate risk identification and assessment procedures.

In addition, in light of the key objective of improving the application of professional scepticism during an audit, we recommend that the IAASB remove the "standback" requirement in ISA 330.18 as we believe that the placement of a requirement to validate, and even override, the risk assessment at a relatively advanced stage of the audit, as well as the specific language used, i.e. "irrespective of [the risk identification and assessment procedures performed]" may serve to reduce the emphasis on the risk identification and assessment process as a critical part of the audit process, and furthermore, may undermine the objective of the IAASB to underscore the importance of professional scepticism during this phase.

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

   (a) **ISA 200 and ISA 240, are these appropriate to reflect the corresponding changes made in ISA 315 (Revised)?**

   Yes, we believe these are appropriate and are aligned to ED 315.

   (b) **ISA 330, are the changes appropriate in light of the enhancements that have been made in ISA 315 (Revised), in particular as a consequence of the introduction of the concept of general IT controls relevant to the audit?**

Yes we are supportive of these, subject to the comments above, in particular, re GITCs, and also the spectrum of inherent risk.

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

Yes, we believe they are.

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

We do not believe these conforming amendments are appropriate. In accordance with ED ISA 315, appropriately robust risk identification and assessment procedures should have been performed, including identification of significant risks, which includes focus on inherent risk factors that are qualitative. Accordingly, inclusion of the concept of "qualitatively material" in ISA 330 may cause confusion or serve to undermine the auditor's determination that they have performed sufficient and appropriate risk identification and assessment procedures.

Please refer also to our comment above, in which we suggest removal of the standback requirement at ISA 330.18.

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

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

We highlight that our concerns with certain inconsistencies in terminology, e.g. "controls", "relevant to the audit", and "relevant to financial reporting" may be exacerbated in jurisdictions in which the ISA is translated from English, as there is additional scope for misunderstanding and confusion in the translation exercise.

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(b) Effective Date – recognizing that ED-315 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods beginning at least 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

We believe this is a reasonable implementation period.