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GAO's Response to the International Auditing and Assurance Standards Board's July 2018 Exposure Draft, Proposed International Standard on Auditing 315 (Revised), *Identifying and Assessing Risks of Material Misstatement and Proposed Consequential and Conforming Amendments to Other ISAs*

Dear Mr. Montgomery:

This letter provides GAO's response to the exposure draft, Proposed International Standard on Auditing 315 (Revised), *Identifying and Assessing Risks of Material Misstatement and Proposed Consequential and Conforming Amendments to Other ISAs* (ED-315). GAO promulgates generally accepted government auditing standards, which provide professional standards for auditors of government entities in the United States.

We support the International Auditing and Assurance Standards Board's (IAASB) efforts to update the standards for identifying and assessing risks of material misstatement. However, we believe that the proposed standard could benefit from further clarifying the following:

- the order of the steps in obtaining an understanding of the entity and its environment and identifying and assessing risks of material misstatement;
- the interdependency of the components of internal control on the design, implementation, and operating effectiveness of controls; and
- the identification of controls relevant to the audit.

Our responses to the IAASB's questions follow. We believe that our suggestions will improve clarity of the standard and will enhance auditors' identification and assessment of risks of material misstatement.

IAASB's Questions

Overall 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)?**

Generally, we support the changes to the standard that increase the understanding of the process for identifying and assessing risks, including the flowcharts that help to illustrate the flow of the process. However, we believe that the standard could benefit from further clarifying the order of the steps in the risk identification and assessment process to increase the understandability and to promote consistent and robust implementation of the standard. While the proposed standard discusses the iterative and dynamic nature of the risk identification and assessment process, in our view, auditors may find the process confusing, which may lead to continued practice issues.

For example, we suggest that the IAASB clarify that the auditor identifies and assesses inherent risk and control risk at the assertion level before assessing risks of material misstatement at the assertion level. The introductory phrase “for identified risks of material misstatement” in paragraphs 48 and 50 implies that the auditor identifies risks of material misstatement before assessing inherent risk and control risk. However, in our view, auditors assess inherent risk and control risk in order to identify risks of material misstatement at the assertion level.

Also, in certain instances, the proposed standard requires the auditor to assess risks of material misstatement before completing the process for obtaining an understanding of the entity and the environment. For example, paragraph 39(b) requires the auditor to obtain an understanding of the control activities component by evaluating the design and implementation of controls that address significant risks. Also, paragraph 35(c) requires the auditor to obtain an understanding of the information system as it relates to preparing disclosures and to accounting estimates relating to significant classes of transactions, account balances, and disclosures. However, an auditor cannot identify significant risks and significant classes of transactions, account balances, and disclosures until the auditor has assessed inherent risk and risk of material misstatement at the assertion level.

We have noted that paragraph 9 of the proposed standard states that the auditor “develops initial expectations about potential risks of material misstatements and potential significant classes of transactions, account balances, and disclosures.” However, it is not clear how and when the auditor should use these initial expectations in applying the requirements. Also, while application guidance in the proposed standard explains the interaction of assessing risk and obtaining an understanding of the entity’s system of internal control, in our view, the IAASB should enhance the requirements in the standard to make this interaction more clear.

(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?

As noted above, we believe that the standard could benefit from further clarifying the following:

- the order of the steps in obtaining an understanding of the entity and its environment and identifying and assessing risks of material misstatement (see response to question 1(a));
- the interdependency of the components of internal control on the design, implementation, and operating effectiveness of controls (see response to question 5(a)); and

- the identification of controls relevant to the audit (see response to question 5(b)).

We also suggest that the IAASB consider adding additional application guidance illustrating examples of risks that could lead to misstatement in specific assertions. For example, the guidance could note that for the occurrence assertion, there is a risk that unauthorized transactions are entered and not detected. In our view, there are generally multiple risks or sources of misstatement related to each assertion, and identifying and considering each of them is important to the completeness of the auditor's risk assessment.

Also, as a more specific point, we suggest that the IAASB consider deleting the following sentence in paragraph A16: "The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity." In certain instances, the auditor may have a better understanding than management. For example, the auditor may have a better understanding of the regulatory or economic environment.

(c) Are the new introductory paragraphs helpful?

In general, we support the IAASB's addition of introductory paragraphs. We believe that they provide a helpful overview of the standard. However, as discussed in our response to question 1(a), we believe that the IAASB should clarify the order of the steps in obtaining an understanding of the entity and its environment and identifying and assessing risks of material misstatement.

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?

In general, we agree that the requirements and application material of ED-315 are sufficiently scalable, enabling auditors to apply ED-315 to the audits of entities with a wide range of sizes, complexities, and circumstances. We suggest that the IAASB rephrase the last sentence of paragraph A116 to clarify that regardless of whether the risk assessment process is formally established, the auditor is still required to obtain an understanding as detailed in paragraph 29. Also, as discussed in our response to question 5(c), we believe that ED-315's discussion of information technology (IT) should recognize the potential effect of general controls on an IT environment consisting of commercial software. For example, inadequate access controls could result in inadequate segregation of duties.

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 to enhance ED-315 in relation to automated tools and techniques. We have not identified other areas within ED-315 where further guidance related to these is needed.

4) Do the proposals sufficiently support the appropriate exercise of professional skepticism 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 skepticism?

We believe that the proposals sufficiently support the appropriate exercise of professional skepticism throughout the risk identification and assessment process, and we support the proposed change for the auditor to obtain “sufficient appropriate audit evidence” to provide the basis for identifying and assessing risks of material misstatement. We believe that this clarification will further encourage auditors to exercise professional skepticism.

However, we do have two specific points for the IAASB to consider:

1. We believe that paragraph A22 could benefit from incorporating text similar to that in paragraph 18(a), specifying that inquiries should be made of individuals “within the entity who in the auditor’s judgment may have information that is likely to assist in identifying risk of material misstatement.”
2. We also suggest that the IAASB reword the first sentence of paragraph A44, which seems to suggest that the engagement team has the option but is not required to exercise professional skepticism while performing risk assessment procedures. We believe that the explanation of this paragraph in appendix 1 of the explanatory memo is clearer; it notes that the engagement team has the opportunity to exercise professional skepticism during the engagement team discussion.

Specific Questions

5) Do the proposals made relating to the auditor's understanding 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 or 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?

We believe that it is clear why the auditor should obtain an understanding of each component of the entity’s system of internal control and how this understanding informs the risk identification and assessment process. To appropriately enhance the requirements related to the auditor’s understanding, we suggest that the IAASB consider whether the standard should emphasize the interdependency of the components of internal control on the design, implementation, and operating effectiveness of controls. The standard could include guidance that the auditor cannot conclude on the effectiveness of internal control unless the auditor has evaluated the design, implementation, and operating effectiveness of internal control for all components of internal control. Our understanding of ED-315 is that the auditors will be required to obtain an understanding of each component of the entity's system of internal control, but will only be required to evaluate design and implementation for (1) information system controls relevant to financial reporting and (2) control activities relevant to the audit. The

Committee of Sponsoring Organizations of the Treadway Commission's 2013 *Internal Control—Integrated Framework* provides that if a component or relevant principle is not present and functioning, or the components are not operating together in an integrated manner, then a system of internal control cannot be effective. Therefore, we suggest that the IAASB consider adding guidance that the auditors may consider evaluating the design and implementation for all components of internal control during their identification and assessment of risks of material misstatement if they intend to conclude on the effectiveness of internal control.

Also, in paragraph 30, we suggest that IAASB delete “the auditor shall evaluate whether any such risks are of a kind that the auditor expects would have been identified by the entity’s risk assessment process.” We believe that if the auditor identifies risks of material misstatement that management failed to identify, the auditor should obtain an understanding of why the entity’s risk assessment process failed to identify such risks and consider the implications for the determination of whether the nature of the entity’s risk assessment process is appropriate to its circumstances. We believe that the auditor should obtain this understanding and consider the implications regardless of whether the auditor would have expected management to identify the risks.

Lastly, in paragraph 37, we believe that auditor’s understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relevant to financial reporting should include an understanding of communications between management and entity personnel.

(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?

We suggest that the IAASB consider further clarifying the requirements related to the auditor identifying controls that are relevant to the audit. We have some concerns that paragraph 39(e) allows a significant amount of flexibility in determining which controls the auditor is required to evaluate.

(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. We also generally support the enhanced requirements and application material related to the auditor’s understanding of the IT environment, identification of the risks arising from IT, and identification of general IT controls. However, we believe that ED-315’s discussion of IT should recognize the potential effect of general controls on an IT environment consisting of commercial software. For example, inadequate access controls could result in inadequate segregation of duties.

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:

- (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 separate assessments of inherent and control risk at the assertion level. As noted in our response to question 1(a), we suggest that the IAASB consider clarifying that auditors should start their assessment of risk of material misstatement by identifying and assessing inherent risk and control risk at the assertion level.

- (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?**

We support the introduction of the concepts and definitions of inherent risk factors to help identify risks of material misstatement and assess inherent risk. We believe that there is sufficient guidance to explain how these risk factors are used in the auditor's risk assessment process.

- (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 support the introduction of the phrase spectrum of inherent risk and the related concepts of assessing the likelihood of occurrence, and magnitude, of a possible 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 support the introduction of the new concepts and related definitions of significant classes of transactions, account balances, and disclosures and their relevant assertions. As discussed in our response to question 1(a), the proposed standard will require the auditor to assess risks of material misstatement before completing the process for obtaining an understanding of the entity and the environment. For example, paragraph 35(c) requires the auditor to obtain an understanding of the information system as it relates to preparing disclosures and to accounting estimates relating to significant classes of transactions, account balances, and disclosures. However, an auditor cannot identify significant classes of transactions, account balances, and disclosures until the auditor has assessed risk of material misstatement at the assertion level. While we have noted that the proposed standard explains the interaction of risk assessment and obtaining an understanding the entity's system of internal control in application guidance, in our view, the IAASB should enhance the standard to further clarify this interaction.

- (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 the revised definition, and related material, on determining significant risks. We agree that significant risks could include risks that are potentially low in likelihood but for which the magnitude of misstatement could be very high if they occurred.

- 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 support the additional guidance in relation to the auditor's assessment of risks of material misstatement at the financial statement level, including determining how, and to what degree, such risks may affect risk assessment at the assertion level.

- 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 believe that both the proposed stand-back requirement in paragraph 52 of ED-315 and the revisions made to paragraph 18 of International Standard on Auditing (ISA) 330 and its supporting application material should be retained.

Conforming and Consequential Amendments

- 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)?**

We believe that the proposed amendments to ISA 200 and ISA 240 appropriately reflect the corresponding changes made in ISA 315 (Revised).

- (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?**

We believe that the proposed amendments to ISA 330 are appropriate in light of the enhancements that have been made in ISA 315 (Revised).

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

We believe that the proposed amendments to the other ISAs, as presented in appendix 2, are appropriate and complete.

- (d) ISA 540 (Revised) and related conforming amendments (as presented in the Supplement to this exposure draft), are these appropriate and complete?**

We believe that the proposed amendments to ISA 540 are appropriate and complete.

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 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, which aligns with the scope of the proposed stand-back in ED-315.

Request for General Comments

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 are not providing comments in response to this question.

(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 that an 18-month transition period for the effective date is appropriate.

Thank you for the opportunity to comment on these important issues. If you have questions about this letter or would like to discuss any of the matters it addresses, please contact me at (202) 512-3133 or dalkinj@gao.gov.

Sincerely yours,



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Director
Financial Management and Assurance