



2 November 2018

Our Ref.: C/AASC

International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th Floor,
New York
NY 10017
USA

Dear Sirs,

IAASB Exposure Draft, Proposed ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only statutory body in Hong Kong that sets auditing and assurance standards, ethical standards and financial reporting standards. We welcome the opportunity to provide our comments on the captioned IAASB Exposure Draft (ED-315).

We support the IAASB's commitment in revising the standard such that it stays relevant in the face of continually changing circumstances. We appreciate IAASB's efforts to restructure and modernize ISA 315 (Revised), and agree that the enhanced and clarified requirements promote consistency in auditor's risk assessment process. However, ED-315 might be over-engineered particularly for small and medium practitioners (SMPs). It should be emphasized that the application material are only to guide practitioners in their implementation and to be applied where appropriate in the specific circumstances of the entities.

Our responses to the specific questions in ED-315 are included in the attachment. We trust that our comments are of assistance to the IAASB in deciding the next steps. If you require any clarification on our comments, please do not hesitate to contact our Selene Ho, Deputy Director at selene@hkipa.org.hk.

Yours faithfully,

Chris Joy
Executive Director

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HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS'
COMMENTS ON THE IAASB'S EXPOSURE DRAFT
ISA 315 (REVISED) IDENTIFYING AND ASSESSING
THE RISKS OF MATERIAL MISSTATEMENT

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?)

(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?

(c) Are the new introductory paragraphs helpful?

The introductory paragraphs help to set the scene and explain key concepts. The flowcharts are extremely useful in providing readers a summary of the risk assessment process and should be included as part of the final standard. They enable readers to understand the flow and how the requirements interact.

- 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 appreciate the efforts of IAASB building in relevant guidance for smaller and less complex entities into the application and explanatory material. Given the length of ED-315, the inclusion of references of key concepts to relevant paragraphs as an appendix to the standard (for example, tables in Appendix 1 of the explanatory memorandum to ED-315) would be helpful for users to locate relevant requirements and application material.

The enhanced requirements on understanding IT environment include understanding the entity's use of IT in its business and system of internal control. The guidance in A149 highlights how the understanding of the entity's IT environment may be more easily accomplished by smaller and less complex entities. As currently drafted, it appears that the SMPs would require IT knowledge to understand. It would be helpful if the IAASB could clarify whether the specific matters set out in A149 are to be considered by an auditor without engaging an IT expert.

In trying to build in scalability, we note in various paragraphs such as A4, A107 and A113 where references are made to an entity's culture or informal, but effective



communication by management. Greater clarity and guidance would be useful on how would the auditor observe such culture or where controls are not explicitly documented, but implied or exhibited by a key management personnel.

- 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?**

It is helpful for IAASB to enhance its guidance on the use of automated tools and techniques. We consider further guidance should be provided on types or examples of audit procedures in assessing commercial software where entities do not have access to the underlying source code.

- 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?**

In general, we are supportive for the auditor to obtain "sufficient appropriate audit evidence" through the performance of risk assessment procedures. We believe this would give auditors a better basis for the identification and assessment of the risks of material misstatement.

Principles-based auditing standards provide a framework without the need for detailed rules. This approach also provides the basis of professional judgment. While one of the objectives of ED-315 is to reinforce professional skepticism, we are concerned that the lengthy application material may give an impression that applying the relevant, if not all, requirements and application material in ED-315 is equivalent to the exercise of professional skepticism.

Specific Questions

- 5. Do they 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?**

- (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?

- (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?**

In general, the proposed requirements and application material have been appropriately enhanced and clarified in relation to the auditor's understanding of each component of the entity's system of internal control and identification of controls relevant to the audit. We welcome the scalability consideration, for instance, paragraph A90 highlights that the nature, timing and extent of procedures to understand the entity's system of internal control will vary from entity to entity and may depend on factors such as size and complexity of the entity.

A key consideration will be how much understanding (thus expected level of documentation) is needed for auditors to illustrate their 'thought process' in risk identification and assessment, given that the extent of understanding of the entity's system of internal control varies depending on factors in A90.

We note in paragraph 36 that the auditor is required evaluate the design of the information system controls relevant to financial reporting, by understanding how the matters in paragraph 35(a)-(d) are addressed by the entity, and implemented. In the application material in paragraph A154, the auditor is to consider whether such controls would meet their financial reporting objectives, if implemented as designed and operating effectively. It would be helpful for the IAASB to clarify whether the auditor is expected to test operating effectiveness.

- 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?**

Risk of material misstatement is a function of inherent risk and control risk. Assessing separately the inherent and control risks would require auditor's in-depth understanding of the entity and relevant internal controls.

As part of the scalability application, paragraph A90 highlights that the nature, timing and extent of procedures to understand the entity's system of internal control will vary from entity to entity and may depend on factors such as size and complexity of the entity. Consequently, the separate assessments may result in substantial increase in work and documentation in case of a small and less complex entity.



Our SMPs stakeholders have commented that as the assessed risks of material misstatements at assertion level are determined by considering both the inherent risk and control risk, they should be considered collectively rather than separately. Such collective consideration allows for inherent risks to be reduced or mitigated by reduced or low control risks. If such mitigation or reduction of risks is allowed, separate assessments are not necessary.

(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 are supportive of the introduction of the concepts and definitions of "inherent risk factors". Whilst the application material provides better understanding of the inherent risk factors, the risk assessment process may now require more effort and thought 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 believe the "spectrum of inherent risk" will facilitate greater consistency.

(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?

Under paragraphs 45 and 46 of ED-315, the auditor first identifies the risks of material misstatement at the financial statement level or assertion level, then goes on to determine significant classes of transactions, account balances and disclosures and their relative assertions ('COTABD') based on the identified risks of material misstatement. We therefore consider significant COTABD are those with identified significant risks which require audit effort under paragraph 21 of the extant ISA 330.

We note that there is no proposed conforming amendment to paragraph 21 of ISA 330.



(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 agree that the revised definition of 'significant risk' in the context of relative spectrum of inherent risk would enhance auditor's understanding and promote consistency in application. We believe it will be helpful if the application material could provide considerations or scenarios that would trigger the conclusion of a significant risk.

Referring to paragraph 57 of the explanatory memorandum, we believe assessing the relative risk spectrum when there is a high magnitude of potential misstatement but a low expectation of the risk occurring requires professional judgment and more guidance and example scenario is needed in this aspect.

Our SMP stakeholders are of the view that the likelihood of occurrence and magnitude of potential misstatements should be considered collectively to make a conclusion as to whether a risk constitutes "significant risk" as opposed to the use of a rigid definition of having to the word "or" to deem all risks of high magnitude of potential misstatement but low likelihood of occurring as "significant risks".

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?

Additional guidance or application material should be provided on the interaction between risks of material misstatement at the financial statement level and 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?

Under paragraph 45 and 46 of ED-315, items that are qualitatively material, in general, would have been identified as significant items. Under paragraph 52, the auditor shall identify items that are quantitatively or qualitatively material, but have not been identified as significant items.

We find the requirements under paragraph 52 confusing to distinguish between significant classes of transactions, account balances and disclosures, against material classes of transactions, account balances and disclosures. The stand-back requirement under paragraph 52 might unintentionally lead auditors to believe that the risk assessment performed under paragraph 45 and 46 do not cover items that are not significant (i.e. inherent risk not along the upper end of the spectrum), yet present reasonable likelihood of material misstatements quantitatively.



We believe that it is more effective if the stand-back requirements are imposed on either significant or material items as opposed to only material items. We also suggest that paragraph 52 or the relevant application material be more explicit in its wording and clarify the intention of the stand-back provision, i.e. an evaluation of the completeness of significant COTAB. The linkage between paragraph 18 of ISA 330 and proposed paragraph 52 of ED-315 should be consistent with the decision on whether the stand-back requirements are imposed on either or both significant items.

In addition, paragraph 52 and the application material do not provide adequate documentation requirements on the stand-back provision to demonstrate auditor's thought process in concluding the risk assessment. We recommend that the documentation requirements or application material is expanded to address the nature and extent of documentation required in relation to the stand back provision.

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

No change is noted for conforming changes to paragraph 14(b) of ISA 330 for use of audit evidence from tests of relevant and unchanged controls in a maximum cycle of three years in prior audits. It is unclear as to whether such testing results of operating effectiveness from prior audits remain relevant in all assessments of control risks. If the tests of operating effectiveness of controls in the current year audit are planned, such testing results appear to be considered. In contrast, they are not taken into account if no tests of operating effectiveness of controls are planned for the current year audit. The testing results in the latter case appear not to be duly considered in the current year audit despite the availability of such relevant audit evidence.

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