



August 2018

Explanatory Memorandum

Exposure Draft 01/18: Proposed Auditing Standard ASA 315 Identifying and Assessing the Risks of Material Misstatement; and Exposure Draft 02/18: Proposed Auditing Standard ASA 2018-1 Amendments to Australian Auditing Standards

Issued by the Auditing and Assurance Standards Board



Obtaining a Copy of this Explanatory Memorandum

This Explanatory Memorandum is available on the Auditing and Assurance Standards Board (AUASB) website: www.auasb.gov.au

Contact Details

Auditing and Assurance Standards Board
Podium Level 14, 530 Collins Street
Melbourne Victoria 3000 AUSTRALIA

Phone: (03) 8080 7400
Fax: (03) 8080 7450
E-mail: enquiries@auasb.gov.au

Postal Address:
PO Box 204, Collins Street West
Melbourne Victoria 8007 AUSTRALIA

COPYRIGHT

© 2018 Auditing and Assurance Standards Board (AUASB). The text, graphics and layout of this document are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source as being the AUASB.

Requests and enquiries concerning reproduction and rights for commercial purposes should be addressed to the Technical Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria 8007 or sent to enquiries@auasb.gov.au. Otherwise, no part of this document may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

ISSN 2201-3644

Explanatory Memorandum Exposure Draft: *Proposed Auditing Standard ASA 315 Identifying and Assessing the Risks of Material Misstatement*

Important Note and Disclaimer

This Explanatory Memorandum is issued by the AUASB to provide information to auditors and assurance practitioners about the AUASB's implementation in Australia of the IAASB's proposed ISA 315 *Identifying and Assessing the Risks of Material Misstatement* and Proposed Consequential and Conforming Amendments.

This Explanatory Memorandum does not establish or extend the requirements under an existing AUASB Standard(s) and is not intended to be a substitute for compliance with the relevant AUASB Standards with which auditors and assurance practitioners are required to comply when conducting an audit or other assurance engagement. No responsibility is taken for the results of actions or omissions to act on the basis of any information contained in this document or for any errors or omissions in it.

CONTENTS

	<i>Paragraph</i>
Purpose	1-3
Composition of ED 01/18 and 02/18	4-6
Exposure Draft Questions	
Background	
IAASB	7-11
AUASB	12-15
The AUASB's approach	16-20
Other Outreach Activities	21
Application	22
Website Resources	23

EXPLANATORY MEMORANDUM

Exposure Draft: *Proposed Auditing Standard ASA 315 Identifying and Assessing the Risks of Material Misstatement*

Purpose

1. The International Auditing and Assurance Standards Board (IAASB) have issued Exposure Draft, ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*, and conforming and consequential amendments (IAASB ED-315).
2. The AUASB is seeking feedback from stakeholders on this ED to inform us when developing our response to the IAASB, and when considering whether there are any compelling reasons for the proposals to be modified for application in Australia.
3. The aim of this Explanatory Memorandum is to provide stakeholders with information about ED 01/18 *Proposed Auditing Standard ASA 315 Identifying and Assessing the Risks of Material Misstatement* (ED 01/18), and ED 02/18 *Proposed Auditing Standard ASA 2018-1 Amendments to Australian Auditing Standards* (ED 02/18), and the Auditing and Assurance Standards Board's (AUASB) approach to implementing in Australia.

Composition of ED 01/18 and 02/18

4. ED 01/18 includes proposed amendments to ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.
5. ED 02/18 includes:
 - (a) the proposed conforming and consequential amendments to ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*, ASA 330 *The Auditor's Response to Assessed Risks*, and ED 03/18 *Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures*.
 - (b) the proposed conforming and consequential amendments to other Australian Auditing Standards are detailed in Appendix 1 of ED 02/18.
6. Where appropriate, IAASB resources have been referred to throughout ED 01/18, ED 02/18 and this Explanatory Memorandum. The IAASB resources which accompany IAASB ED-315, listed below, are available on the [IAASB website](#):
 - IAASB Explanatory Memorandum – includes details on the background and the process adopted by the IAASB in developing IAASB ED-315 and the significant changes proposed;
 - IAASB Flowcharts – Draft flowcharts on *Overall risk assessment*, *Understanding of Internal Control*, and *Understanding of the IT environment*; and
 - IAASB Supplement to Exposure Draft – includes conforming amendments to ED 03/18 *Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures* and ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*.

Exposure Draft Questions

Stakeholders are asked to respond to the AUASB on the following questions in order to inform us when responding to the IAASB:

ED 01/18

1. Has ED 01/18 been appropriately restructured, clarified and modernised 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?
 - (b) Are the [flowcharts](#), prepared by the IAASB, helpful in understanding the flow of the standard (i.e., how the requirements interact and how they are iterative in nature)? If yes, should they be included in the final Standard?
 - (c) 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 of the IAASB’s Explanatory Memorandum.
 - (d) Are the new introductory paragraphs helpful?
2. Are the requirements and application material of ED 01/18 sufficiently scalable, including the ability to apply ED 01/18 to the audits of entities with a wide range of sizes, complexities and circumstances?
3. Do stakeholders agree with the approach taken to enhancing ED 01/18 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 of the IAASB’s Explanatory Memorandum for references to the relevant paragraphs in ED 01/18)? Are there other areas within ED 01/18 where further guidance is needed in relation to automated tools and techniques, and what is the nature of the necessary guidance?
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’¹ 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?
5. Do the proposals made relating to the auditor’s understanding of the entity’s system of internal control² 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?

¹ See paragraph 27 of the IAASB’s Explanatory Memorandum and paragraph 17 of ED 01/18

² Paragraphs 25-44 and A89-A200 of ED 01/18

- (b) Have the requirements related to the auditor's identification of controls relevant to the audit³ 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?
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?⁴
 - (b) Do you support the introduction of the concepts and definitions of 'inherent risk factors'⁵ 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?
 - (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?
 - (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),⁶ and how they assist the auditor in identifying where risks of material misstatement exist?
 - (e) Do you support the revised definition,⁷ and related material, on the determination of 'significant risks'? What are your views on the matters presented in paragraph 57 of the IAASB's Explanatory Memorandum relating to how significant risks are determined on the spectrum of inherent risk?
7. Do you support the additional guidance in relation to the auditor's assessment of risks of material misstatement at the financial statement level,⁸ including the determination about how, and the degree to which, such risks may affect the assessment of risks at the assertion level?
8. What are your views about the proposed stand-back requirement in paragraph 52 of ED 01/18 and the proposed revisions made to paragraph 18 of ASA 330 and its supporting application material? Should either or both requirements be retained? Why or why not?

³ See ED 01/18, paragraphs 39-40 and paragraphs 37-40 of the IAASB's Explanatory Memorandum

⁴ Paragraphs 45-50 and A201-A235 of ED 01/18.

⁵ See paragraph 48 of the IAASB's Explanatory Memorandum and paragraphs 16(f), A5-A6 and A83-A88 of ED 01/18.

⁶ See footnote 26 of the IAASB's Explanatory Memorandum.

⁷ Paragraphs 16(k) and A10, and A229-A231 of ED 01/18.

⁸ Paragraphs 47 and A215-A220 of ED 01/18.

9. Effective date: the IAASB have proposed that the standard will be effective for financial reporting periods commencing no or after 15 December 2020, which is anticipated to be approximately 18 months after approval of the final ISA. Do you think this is a sufficient period to support effective implementation of the new standard?

ED 02/18

10. With respect to the proposed conforming and consequential amendments to:
- (a) ASA 200 (including Appendix 2), ASA 240 and ED 03/18, are these appropriate to reflect the corresponding changes made in proposed ASA 315?
 - (b) ASA 330, are the changes appropriate in light of the enhancements that have been made in proposed ASA 315, in particular as a consequence of the introduction of the concept of general IT controls relevant to the audit?
 - (c) The other ASAs as presented in Appendix 1, are these appropriate and complete?
11. Do you support the proposed revisions to paragraph 18 of ASA 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 proposed ASA 315?
12. Effective Date: the IAASB have proposed that the standard will be effective for financial reporting periods commencing on or after 15 December 2020, which is anticipated to be approximately 18 months after approval of the final ISA 315. Do you think this is sufficient period to support effective implementation of the new standard?

Australian specific questions (for both ED 01/18 and 02/18)

The AUASB is especially interested in stakeholders views on:

13. Have applicable laws and regulations been appropriately addressed in the proposed standard? Are there any references to relevant laws or regulations that have been omitted?
14. Whether there are any laws or regulations that may, or do, prevent or impede the application of the proposed standard, or may conflict with the proposed standard?
15. Whether there are any principles and practices considered appropriate in maintaining or improving audit quality in Australia that may, or do, prevent or impede the application of the proposed standard, or may conflict with the proposed standard?
16. What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the main changes to the requirements of the proposed standard? If significant costs are expected, the AUASB would like to understand:
- (f) Where those costs are likely to occur;
 - (g) The estimated extent of costs, in percentage terms (relative to audit fee); and
 - (h) Whether expected costs outweigh the benefits to the users of audit services?
17. What, if any, implementation guidance auditors, preparers and other stakeholders would like the AUASB to issue in conjunction with the release of ASA 315 (specific questions/examples would be helpful).
18. Are there any other significant public interest matters that stakeholders wish to raise?

Background

IAASB

7. A strategic objective of the IAASB is to ensure the International Standards on Auditing (ISAs) continue to form the basis for high quality, valuable and relevant audits conducted worldwide by responding on a timely basis to issues noted in practice and emerging developments.
8. IAASB ED-315 is part of the IAASB's commitment to advancing audit quality globally.
9. ED 01/18, the Australian equivalent of IAASB ED-315, proposes essential enhancements to the auditor's risk assessment process, with the objective of establishing more robust requirements and appropriately detailed guidance to drive auditors to perform consistent and effective identification and assessment of the risks of material misstatement.
10. The more significant changes proposed in ED 01/18 are:
 - a comprehensive introduction section which provides an overview of the key concepts including an overview of the risk assessment process
 - new definitions including the definitions of inherent risk factors, relevant assertions and significant risk
 - a new "stand-back" requirement to re-assess and confirm the appropriateness of the auditor's assessment of classes of transactions, account balances and disclosures that are quantitatively or qualitatively material, and that have not been identified as significant
 - a new requirement to separately assess inherent risk and control risk
 - enhanced guidance in relation to scalability
 - increased emphasis on professional scepticism and the auditor's considerations relating to fraud
 - enhanced requirements and application material in relation to identifying and assessing IT applications, the risks arising from IT and general IT controls relevant to the audit
 - new application material in relation to how automated tools and techniques may be used in the risk assessment process
 - extended application material to provide guidance to the requirements.
11. Further details can be found on the IAASB's website: <http://www.ifac.org/auditing-assurance>

AUASB

12. The AUASB has a strategic objective to develop, issue and maintain high quality Australian Auditing Standards. The AUASB takes input received from Australian stakeholders into account when preparing its submissions to the IAASB. The AUASB makes formal submissions on EDs issued by the IAASB to contribute to the setting of international auditing and assurance standards.
13. In accordance with its mandates under section 227 of the *ASIC Act 2001* and the Financial Reporting Council's (FRC) Strategic Direction, the AUASB's policy is to adopt the IAASB's auditing standards (ISAs), unless there are compelling reasons not to do so; and to amend the ISAs only when there are compelling reasons to do so. The AUASB's principles of convergence with the ISAs and harmonisation with the New Zealand auditing standards can be found on the AUASB's website:

http://www.auasb.gov.au/admin/file/content102/c3/Aug14_IAASB-NZAuASB_Principles_of_Convergence_and_Harmonisation.pdf

14. Compelling reasons fall broadly into two categories: legal and regulatory; and principles and practices considered appropriate in maintaining or improving audit quality in Australia. Compelling reasons are further guided by the AUASB's policy of harmonisation with the standards of the New Zealand Auditing and Assurance Standards Board (NZAuASB).
15. The AUASB will adopt the revised ISA 315 into the Australian Auditing Standards that are made under section 336 of the *Corporations Act 2001*. Prior to implementation, the AUASB is required to consult with stakeholders and accordingly now issues Exposure Draft ED 01/18 and 02/18 for public exposure and comment. All comments received from stakeholders are considered by the AUASB when providing comments to the IAASB and prior to finalisation of the proposed revised standard.

The AUASB's approach

Exposure Draft Protocols

16. The AUASB has developed ED 01/18 and ED 02/18 based on the IAASB's equivalent ED-315. The AUASB is seeking feedback from stakeholders to inform us when responding to the IAASB on ED-315, and to identify compelling reasons when it may be appropriate to amend ISA 315.
17. Under its convergence policies, the AUASB continues to include requirements and guidance that are in addition to, or a clarification of, the equivalent ISA, only when the compelling reason test has been met. Any such modifications continue to be identified in the Australian Auditing Standards by paragraph numbering commencing with an "Aus" prefix. Any such changes do not diminish the requirements of the equivalent ISA.
18. In addition to those changes that meet the compelling reason test, the AUASB makes format and terminology changes to comply with requirements relating primarily to legislative instruments. Such changes are mechanical in nature and do not change the meaning of the equivalent ISA.

General

19. ED 01/18 and ED 02/18 will be open to stakeholders for a **70 day comment period** closing on 15 October 2018. This is to allow stakeholders time to respond to the AUASB on the EDs, and for the AUASB to conduct further outreach and to collate all feedback into our submission to the IAASB due on 2 November 2018.
20. At the completion of the exposure period, the AUASB will consider stakeholders' submissions:
 - (a) to inform us when developing our response to the IAASB on their ED; and
 - (b) where the AUASB determines that a compelling reason exist, to inform us as to whether modifications may be required when we are adopting the final standard.

Other Outreach Activities

21. In addition to the public exposure process, during September and October 2018 the AUASB will conduct roundtable consultative meetings and a webinar, in conjunction with the AUASB exposure draft ED 03/18 Proposed ASA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*.

Application

22. It is proposed that the revised standard will be applicable for financial reporting periods **beginning on or after 15 December 2020**. This application date corresponds with that of the equivalent ISA.

Website Resources

23. The AUASB welcomes stakeholders' input to the development of Australian Auditing Standards and regards both supportive and critical comments as essential to a balanced review of the proposed standards. Stakeholders are encouraged to access the websites of the [AUASB](#) and the [IAASB](#) to obtain further information.

* *