



Auditing and Assurance Research Network
School of Accounting
UNSW Business School

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Mr Matthew Zappulla
Technical Director
Australian Auditing and Assurance Standards Board
Podium Level 14
530 Collins Street
Melbourne VIC 3000

Dear Matthew

**Re: Proposed Auditing Standard ASA315 (ED 01/18)
Identifying and Assessing the Risks of Material Misstatement**

The Auditing and Assurance Research Network at UNSW Sydney is pleased to comment on Proposed Auditing Standard (ED01/18) ASA315 'Identifying and Assessing the Risks of Material Misstatement'. The Auditing and Assurance Research Network is one of eight research clusters within the UNSW Business School, leveraging off leading global research strengths.

The response combines the views of three network members; Scientia Professor Ken Trotman, Associate Professor Noel Harding and Dr Wei Chen. In preparing our response, we focus on our areas of expertise and our own research, together with research that provides additional elaboration on our views. Our response does not represent a census of all research, and we do not comment on all questions. Specifically, we provide a response to Questions 4, 6(a) and 6(d)

If you have any questions on our submission, please contact any of the undersigned.

Yours Sincerely

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General Comment

Overall, we are supportive of the proposed auditing standard and commend those involved in its development for their work. It is our belief that the revised standard will lead to a more robust and comprehensive risk assessment process.

However, on the basis of our own research, and that of our colleagues, we believe that there are opportunities to further improve the standard and we note our comments below. In preparing our response we focus on our areas of expertise as they relate to the proposed standard. We provide a response to Questions 4, 6(a) and 6(d).

Question 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 identification and assessment of the risks of material misstatement, and do you believe this clarification will further encourage professional scepticism?

Our own research, and that of others, suggests that the proposals will support the appropriate exercise of professional scepticism throughout the risk identification and assessment process, especially as it relates to fraud risk. In particular, discussions among the engagement team (paragraphs 22, A41-A45) have been shown to result in higher levels of professional scepticism. We feel, however, that additional explanatory material emphasising that the engagement partner should consider the format of the discussion, and how to communicate with those not in attendance at the discussion, would be beneficial in supporting the appropriate exercise of professional scepticism.

Paragraph 22 (and the related explanatory material) is silent on the format that engagement team discussions should take. We believe that there is merit in noting that different formats may be more or less effective, depending on the circumstances. Our research (Trotman, Simnett and Khalifa 2009; Chen, Khalifa, Morgan and Trotman 2018; Chen, Trotman and Zhou 2015; Trotman, Bauer and Humphreys 2015), consistent with a number of other studies (e.g., Carpenter and Reimers 2013; Dennis and Johnstone 2018), highlight that differences in the nature and format of the discussion (e.g., face-to-face or electronic brainstorming), and those involved in the discussion, can facilitate or impede a robust risk assessment process. To illustrate, we (Trotman, Simnett and Khalifa 2009) find that different group formats and different instructions to group members affected the number and nature of potential frauds identified. In another study (Chen, Trotman and Zhou 2015), we find that when the discussion takes place via computer interaction (as may be the case when discussion participants are geographically dispersed), discussion impedes the risk assessment process and that this is caused, in part, by less experienced auditors relying on others to provide inputs into the discussion.

While supporting the ongoing requirement for audit team members to discuss the potential for material misstatement, we believe that the risk assessment process would be more robust if paragraph 21, in addition to noting that the engagement partner is to determine which matters are to be communicated to engagement team members not involved in the discussion, also notes that the engagement partner is to use professional judgment to decide the format of, instructions provided, and who will participate, when conducting the discussion. This can also be further elaborated upon in the explanatory material, by noting that the discussion can take many forms and that it is a matter of professional judgment as to what form such discussions should take in order to facilitate a robust risk assessment process.

In addition, our own research (Kim and Harding 2017), consistent with other research highlighting that the preferences of the auditor's firm and superior can influence (both positively and negatively) their judgments (e.g., Peecher 1996; Wilks 2002; Shankar and Tan 2006), provides support for a communication plan (noted as being potentially useful in paragraph A45) in order to minimize deleterious consequences of the engagement partner inappropriately directing the risk assessment process, and to leverage off the benefits that such communication can have on elevating professional scepticism in the risk assessment process.

We have also undertaken research examining the effect on professional scepticism of differences in what the partner communicates to those not involved in the discussion (Harding and Trotman 2017). This research highlights that the nature of the communication with those not involved in the discussion can

have a noticeable effect on the level of professional scepticism exercised by those receiving the engagement partner's communication.

Based on this research, we recommend, in order to encourage professional scepticism in the risk assessment process, that paragraph A45 be expanded to note that the engagement partner should be cognisant, when communicating with those not included in the discussion, that what they communicate, and how they communicate, might lead to auditor bias which can, depending on the circumstances, both positively and negatively impact the level of professional scepticism being exercised.

Also with reference to the exercise of an appropriate level of professional scepticism, we draw attention to recent developments in the academic literature regarding the representation of professional scepticism. The academic literature has, of late, addressed professional scepticism as both a mindset and an attitude (see Nolder and Kadous 2018). Broadly speaking, mindsets (i.e., "judgment criteria and cognitive processes and procedures to facilitate completion of a particular task") directs an auditor's approach to risk assessment, and attitudes (i.e., beliefs and feelings that drive individual intentions and actions") direct an auditor's response to that risk assessment. Both mindsets and attitudes are important in encouraging and supporting an appropriate level of professional scepticism.

With reference to mindsets, the understanding of professional scepticism in the extant standards is consistent with a deliberative mindset that "...is characterized by receptivity, openness or alertness to new information, and an objective and unbiased assessment of the merits of the evidence" (Nolder and Kadous 2018, p.5). Attitudes, by comparison, refer to beliefs and, importantly, feelings that will influence future actions (e.g., response to an identified risk of material misstatement). While the current version of the proposed auditing standard goes some way to encourage and support an appropriate sceptical mindset and attitude, there may be opportunities for further improvements.

We support reference to contradictory evidence / information in paragraphs A19, A42 and A44 in that the search for and consideration of contradictory evidence is indicative of the exercise of professional scepticism (including the identification of troubling patterns). However, in order to further encourage an appropriate level of professional scepticism, we recommend that thought be given to expanding paragraph A19 to refer to broad sources of information (that may include but not limited to the points noted) so as to avoid consciously and/or subconsciously narrowing the breadth of information search. Similarly, we note that particular reference is made to the consideration of contradictory evidence in paragraph A42 and suggest that other benefits of the engagement team discussion can be noted, including helping auditors to be open to new information, and different interpretations of the information, and to limit the possibility of prematurely forming a belief.

Question 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?*

Although not specifically related to separate assessments of inherent and control risk, we (Chen Khalifa and Trotman 2015) find that auditors identify more potential frauds when sequentially considering one risk area at a time (e.g., revenue recognition/receivables, inventory, non-current assets and management estimates). If applied to the unpacking of risk of material misstatement assessments (and we have no reason to expect that our findings would not be applicable), these findings suggest that separate assessments of inherent risk and control risk would result in the identification of more risk factors and a more robust risk assessment process. We therefore support the separate assessment of inherent and control risk.

As a word of caution, however, while more fraud risk factors were identified, auditors in our study assigned a lower likelihood to these fraud risk factors, suggesting that lower levels of scepticism may accompany the 'unpacking' of assessments of risk of material misstatement. Simon, Smith and Zimbleman (2018) similarly report that decomposition of fraud risk assessments into likelihood and magnitude components (compared to a holistic assessment) led auditors to "...discount their fraud risk assessment for higher-risk fraud schemes"(p.3). These results suggest that while unpacking/decomposing the risk of material misstatement may be beneficial by way of increasing auditors' sensitivity to

information, it may limit the scepticism applied to the risks identified. We therefore recommend that the application and other explanatory material relating to paragraph 48 be expanded to reinforce the need to exercise an appropriate level of scepticism across the greater number of identified risks that are likely to follow from the unpacking / decomposition of the components of risk of material misstatement assessments.

(d) Do you support the introduction of 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.

The definition of relevant assertion refers to "... a reasonable possibility of occurrence of a misstatement with respect to that assertion that is material ...". In the definition, this is subsequently explained as "...the likelihood of a material misstatement [that is] more than remote". The definition of relevant assertion, envisages that the terms 'reasonable possibility' and 'more than remote' are equivalent. Indeed, in the IAASB Explanatory Memorandum to ED315 (footnote 26), it is noted that the "IAASB is of the view that the two terms are synonymous". Research would suggest that this is not the case, and equating reasonable possibility with more than remote will likely lead to confusion.

In 2016, the Korea Accounting Standards Board and the Australian Accounting Standards Board reported the results of a survey eliciting Korean and Australian preparers' and auditors' interpretation of linguistic probability statements contained in the International Accounting Standards. Australian preparers and auditors perceived remote to mean a probability of 9.0% (range 3.2% to 12.1%). However, these same preparers and auditors perceived reasonably possible to mean a probability of 57.2% (range 49.7% to 72.7%). Similar results are revealed in Amer, Hackenbrack and Nelson (1994), that is; remote: 12.33%, reasonably possible: 58.57%. There are, therefore, a broad range of likelihoods (approximately 10% to 50%) that, while being more than remote, are not reasonably possible. This difference between more than remote and reasonable possibility highlights the dangers in attempting to define one linguistic probability term with reference to another linguistic probability term, and this is even more the case when the terms are clearly perceived to be different. Between remote and reasonably possible in the joint KASB/AASB study were, from less likely to more likely; extremely unlikely, highly unlikely, unlikely and possible. We would not recommend defining one linguistic probability statement in terms of another.

Whether the term 'reasonable possibility' or 'more than remote' is employed rests on standard setters' preference for the standard to capture more or less assertions. The term 'more than remote' will capture more assertions than 'a reasonable possibility'. We do not offer any comment on which of these two terms is better.

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