

15 October 2018

The Chair
Australian Auditing and Assurance Standards Board
PO Box 204
Collins St West Victoria 8007
AUSTRALIA

Dear Professor Simnett

Request for Comment
ED 01/18 Proposed Auditing Standard ASA 315 Identifying and Assessing the Risk of Material Misstatement and
ED 02/18 Proposed Auditing Standard ASA 2018 -1 Amendments to Australian Auditing Standards

The Australasian Council of Auditors-General (ACAG) welcomes the opportunity to comment on exposure drafts 01/18 *Proposed Auditing Standard ASA 315 Identifying and Assessing the Risk of Material Misstatement* and 02/18 *Proposed Auditing Standard ASA 2018 -1 Amendments to Australian Auditing Standards*.

The views expressed in this submission represent those of all Australian members of ACAG.

ACAG's comments are primarily in the context of the public sector, which reflects ACAG's significant experience and involvement in the sector.

Overall ACAG generally agrees with the changes within ED 01/18 and ED 02/18. We have, however, identified some areas where we believe the Board should consider providing guidance to help operationalise and ensure compliance with, the requirements within the proposed standard.

ACAG appreciates the opportunity to comment and trust that you will find the attached comments useful.

Yours sincerely



Andrew Richardson
Chairman
ACAG Audit Standards Committee

Attachment

Specific Matters for Comment

ED 01/18: Proposed Auditing Standard ASA 315 *Identifying and Assessing the Risk of Material Misstatement*

1. Has ED 01/18 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 process?

ACAG agrees that there is generally an improvement in understandability and description of risk.

Service entity use is rising and should be considered when obtaining an understanding of the entity's system of internal control. ACAG considers that additional considerations in this standard or ASA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* would be beneficial.

(b) Are the flowcharts, prepared by the IAASB, helpful in understanding the flow of the standard? If yes, should they be included in the final standard?

ACAG supports flowcharts being included in the final standard. The flowcharts clarify both the logical flow of the standard and clearly describe the processes required of auditors to understand the control environment.

(c) Will the revisions promote a more robust process for the identification and assessments of the risks of material misstatements and if they appropriately address the public interest issues outlined in paragraphs 6-28 of the IAASBs Explanatory Memorandum?

ACAG agrees that the revisions will promote a more robust risk assessment process. We are supportive of the clarification that when the operating effectiveness of controls are not tested the auditors shall assess controls risk at the maximum.

The public interest issues are reasonably well addressed. ACAG makes the following comments in relation to specific aspects of the proposed requirements:

- The inherent risk factor of susceptibility to management bias is a helpful clarification and distinction to fraud risks, as are the broader statements regarding qualitative aspects.
- The auditor's use of data analytics tools in risk assessments is not well considered and ACAG makes further comment on this under question 3 below.
- Considerations specific to the public sector do not articulate our requirements to consider the risks of probity and propriety and the need to comply with legislated financial accountability frameworks (A36).

- Although paragraph A51 encourages the auditor to consider the responsibilities of those charged with governance for oversight of financial reporting, this paragraph does not address the need for an auditor to also consider the responsibilities of those charged with governance for the accuracy and relevance of the data used in business intelligence reporting.

(d) Are the new introductory paragraphs helpful?

ACAG agrees that the new introductory paragraphs are 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 range of sizes, complexities and circumstances?

ACAG considers scalability is limited by using the term “small **and** less complex” throughout the standard. Complexity is a key factor in determining most aspects of audit risk and audit response. The use of “small **or** less complex” or “simpler and less complex” would improve scalability as there are large non-complex audits. The public sector has many examples of large non-complex audits, such as policy Departments where funds are merely administered on behalf of central agencies. Similar examples can exist in the private sector in the form of large controlled entities.

We consider that the examples of complexity throughout the ED are well documented however, from our interpretation, an entity will have a de-facto higher risk if it is large and less complex.

The definition of “reasonable possibility” is where the likelihood of material misstatement is more than remote. A “remote possibility” is a much lower threshold than “reasonably possible”. If it is intended that “reasonable possibility” and “remote possibility” are not explicitly defined, ACAG suggest further guidance be provided. This can be in the form of criteria for auditors to consider when assessing reasonable possibility versus remote possibility. In the absence of such definitions or clarifying criteria, ACAG questions whether it is the intention for the auditor to apply their professional judgment in making this assessment? Either way, we would support the need for further clarity to aid the auditor in grounding an assessment of “reasonably possible” versus “remote possibility”. In the absence of such guidance, there may be an increase in audit work effort over low risk balances.

The requirements in relation to IT risks and response is sufficiently scalable provided the auditor’s skills, experience and knowledge are equally scalable to the level of understanding of the IT environment.

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? 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?

ACAG’s overall opinion is that the standard does not include enough information about risk factors relating to the use of big data and automated analytics technology. While these technologies are still evolving, they are evolving at a rapid rate and are widely used throughout the profession, in both private and public sectors. We believe guidance is required now to help the profession address the use of big data and automated analytics technology. There is a risk that the standard, when issued for implementation, will be outdated given the rate of technological evolution.

Paragraph 54 (documentation) and paragraphs A15, A18, and A32-A33 discuss that automated tools can be used. However, this application material could be enhanced by:

- providing information about control assessments over data quality, completeness and accuracy once data is extracted from client systems for use by auditors
- commenting on the risk considerations or documentation of judgments specific to the use of predictive analytics or analytic tools that incorporate machine learning or artificial intelligence (AI) by both entities and auditors, particularly the nature of what is considered evidence
- providing guidance for documentation of analytic procedures to allow for re-performance where machine learning is used by an entity and/or auditor
- outlining clear linkages between the underlying need for quality ITGC assurance and database control assurance prior to the use of automated tools
- establishing an expectation about documenting the appropriateness and reliability of external data sets (being data sets external to the entity’s sphere of control)
- describing how audit analytics and automated tools can be used to assess qualitative inherent risks factors described in section A5.

4. Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk identifications 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?

ACAG considers the prompts to consider professional scepticism are sufficient. We support the emphasis on “management bias”, particularly the link to the entity’s financial performance. We consider the most important encouragement of professional scepticism is behavioural change through staff awareness and training.

ACAG supports the emphasis on an appropriate evidence base for risk assessment. If quality evidence is not found to be available at an early stage, the auditor should become more sceptical, continue to challenge management and refine the audit approach as required.

While ACAG supports the intention of this change, we are concerned that the specific requirement for the risk assessment procedures to obtain sufficient appropriate audit evidence as the basis for identification and assessment of risks is unclear. The objective of an audit of financial statements is to draw conclusions on the financial statements as a whole and not on the risks of material misstatement. Risk assessment procedures and other audit procedures work together to allow the auditor to obtain a sufficient and appropriate evidence on which to draw conclusions because audit evidence is cumulative in nature. That is to say, sufficiency and appropriateness of evidence can only be measured when concluding on the subject matter and risk assessment procedures alone may not be able to draw conclusions. For example on a practical level, when taking a controls strategy, the auditor will not have sufficient and appropriate audit evidence of control risk at the conclusion of the risk assessment phase of the audit because procedures related to assessing the operating effectiveness of controls is a risk response procedure. The risk assessment procedures for controls only provide an educated guess as to the likely results of the testing which is not consistent with sufficient and appropriate audit evidence. Similarly, the emphasis on the iterative nature of risk assessments also suggests that the sufficiency and appropriateness of evidence related to risk assessment relies upon the corroboration of the execution of the risk response.

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?

This aspect is enhanced and clarified and shows the link to risk identification. ACAG is supportive of the clarification that when the operating effectiveness of controls are not tested, the auditor shall assess control risk at the maximum.

(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?

The process for identification of relevant controls is enhanced and clarified and consider this can be applied to all types of audits.

(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?

ACAG supports the introduction of IT related concepts and definitions.

ACAG’s overall opinion is that the standard does not include enough information about risk factors relating to current and quickly evolving technology, such as “infrastructure/ software as a service” solutions, wireless networks, blockchain, and other technology devices (Internet of Things) that connect to organisational networks. These are current technologies that are being used in organisations now, including many public sector organisations.

We note:

- the enhanced material is only sufficient for simple in-house IT environments
- understanding the transaction flow for significant classes of transactions, account balances and disclosure COTBAD is an important step and will highlight all the systems involved. However, auditors will need more guidance in understanding “as a service” offerings within the IT environment and the related risks of trusted third parties.
- more guidance is required to understand the end-to-end IT services that relate to processing significant COTBAD for comprehensively identifying and assessing risks resulting from the use of IT
- use of other new technologies, such as Distributed Ledger Technology (including block chain), also present different and additional risks to the control environment that need to be considered when understanding the IT environment.

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?**

ACAG supports the separate assessment of inherent and control risk and agrees the revised requirements and guidance are appropriate.

- (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?**

ACAG supports the concepts of inherent risk factors and agrees the guidance is appropriate.

- (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?**

ACAG agrees with the concept of a “spectrum of inherent risk” and the combined assessment of “likelihood” or “magnitude” when determining significance. We suggest the inclusion of a diagrammatic representation to highlight how likelihood and magnitude interplay in the process of determining if a risk is significant or otherwise, i.e. “likelihood” on one axis and “magnitude” on the other axis.

To ensure appropriate determination of “significant risk”, ACAG suggests additional guidance be inserted to help auditors determine where on the scale of likelihood and magnitude would result in a significant risk, i.e. would a low likelihood and high magnitude instance result in a significant risk?

- (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 exists?**

ACAG is not clear as to the intention of the introduction of this concept as there is minimal guidance as to the difference in auditor response to significant COTABD and material COTABD. Para A242 requires the auditor to address quantitatively and qualitatively material COTABD in accordance with ISA 330 para 18 which states that “the auditor shall design and perform substantive procedures...”

In order to design and perform audit procedures, the auditor would first need to determine the relevant assertion at risk. If that is the case, then ACAG questions the appropriateness of the auditor's response to material COTABDs.

Given the example provided in para A242 refers to a qualitatively material disclosure, it appears the intent to distinguish between significant and material is related to qualitatively material aspects of the COTABD. ACAG questions the benefits of making this distinction if this is the case, as the concept of qualitatively material COTABD is an existing concept and auditors would already be considering the qualitative aspects under the current framework when scoping in their COTABDs.

(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 IAASB’s Explanatory Memorandum relation to how significant risks are determined on the spectrum of inherent risk?

ACAG supports the revised definition and related material on determining risk. We are aware of examples such as IT environments where the likelihood of a risk is low, but the consequence extremely high. Therefore, it is important not to exclude these risks from the auditor's determination of 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?

ACAG supports the additional guidance material. It clarifies how the control environment can have a pervasive effect on financial reporting and fraud.

8. What are your views about the proposed stand-back requirements 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?

ACAG generally supports stand back provisions however it is unclear the benefit of this particular provision. Unlike the stand back provision in the proposed ASA 540 *Auditing Accounting Estimates and Related Disclosures*, this procedure appears unlikely to result in a meaningful improvement to audit quality because it simply requires the auditor to double-check the completeness of risks with respect to material balances. In our view the auditor, in conducting risk assessment procedures to understand the entity, its environment and financial reporting framework, should already have

considered material transactions, balances and disclosures in identifying sources of risk. The application of appropriate levels of skills and experience (including engagement leader review) consistent with ASA 220 *Quality Control for an Audit of a Financial Report and Other Historical Financial Information* is more effective than this stand back requirement in improving the quality of risk assessments.

ACAG believes that the requirements in ASA 330 should be retained because it will continue to enhance the application of qualitative considerations to financial reporting.

9. Effective date: The IAAS 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?

ACAG considers ASA 315 to be a fundamental auditing standard that warrants significant consultation and debate prior to approval. ACAG considers the 18-month post approval period to be sufficient timing to support effective implementation.

ED 02/18 Proposed Auditing Standard ASA 2018 -1 Amendments to Australian Auditing Standards

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?**

ACAG considers the proposed conforming and consequential amendment to ASA 200, ASA 240, ED 03/18 and ASA 330 are appropriate. We would like further considerations to consistency of application for ASA 402, 600 and 620.

11. Do you support the proposed revisions to paragraph 18 of ASA 330 to apply to classes of transactions, account balances or disclosures that re “quantitatively and qualitatively material” to align with the scope of the proposed stand-back in proposed ASA 315?

Subject to the clarification of our concern raised in question 6d) above, ACAG supports this.

12. Effective Date: the IAASB have proposed that the standard will be effective for financial reporting period 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?

ACAG considers the 18-month post approval period to be sufficient timing to support effective implementation.

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

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?

ACAG considers the public sector guidance to be of marginal help, the standard would be strengthened by further guidance with respect to:

- interaction between this standard and additional Auditor-General responsibilities arising out of legislative mandates and Auditor-General audit standards
- the influences of Parliament and the Executive, such as the directions of Shareholding Ministers
- impact or influence of Machinery of Government changes
- explicit statement of the requirements to audit probity and propriety risks.

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?

ACAG is not aware of any such laws and regulations.

15. Whether there are any principles and practices considered appropriate in maintaining or improving quality in Australia, that may, or do, prevent or impede the application of the proposed standard, or may conflict with the proposed standard?

A well-informed risk assessment is critical to audit quality. ACAG has not identified any principles and practices that would compromise audit quality.

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:

- (a) Where those costs are likely to occur
- (b) The estimated extent of costs, in percentage fees (relative to audit fee); and
- (c) Whether expected costs outweigh the benefits to the users of audit services?

ACAG believes some of the adopted terminology may impact scalability and could lead to increased audit costs with little value to the audit process. Examples of this terminology are the concepts of “More than remote” and “small and less complex” rather than “small or less complex”.

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.

ACAG would like further consideration of more advanced data analytic techniques to be considered. For example, the use of predictive analytics as a tool for determining risk and additional guidance on the implications of using population data in assessing risk and determining the audit approach.

18. Are there any other significant public interest matters that stakeholders wish to raise?

ACAG is not aware of any other significant public interest matters.