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Dear Mr Montgomery

**Exposure Draft – Proposed International Standard on Auditing 315 (Revised) Identifying and Assessing the Risks of Material Misstatement**

The Financial Reporting Council (FRC) welcomes the opportunity to comment on the exposure draft of the Proposed International Standard on Auditing 315 (Revised) Identifying and Assessing the Risks of Material Misstatement (ED-315).

Overall, we are strongly supportive of the aims of the IAASB as reflected in the explanatory memorandum in enhancing and providing for a more robust risk assessment process that will support the auditor efforts in achieving high quality audits. Whilst there are many proposals that we would like to see retained when the revised standard is finalised, we are particularly supportive of:

- The emphasis in ED-315 paragraph 17 that the purpose of performing risk assessment procedures is to *obtain sufficient appropriate audit evidence* as the basis for the identification and assessment of the risks of material misstatement. This clarifies that performing risk assessment procedures provides audit evidence in accordance with ISA 500<sup>1</sup>. This should remind auditors to exercise professional scepticism in planning and performing risk assessment procedures to obtain such audit evidence including through considering, and questioning as appropriate, the sufficiency and appropriateness of the audit evidence obtained in light of the circumstances<sup>2</sup>, as the basis for the identification and assessment of the risks of material misstatement.
- The emphasis on the importance of professional scepticism in the introduction to the standard and the guidance in the application material. In particular, by highlighting specific examples where the engagement team have an opportunity to exercise professional skepticism in the identification and assessment of risks.
- The separate identification of inherent risk and control risk. This approach demonstrates greater alignment with ISA 330 and has the potential to drive significant improvements in the auditor's risk assessment process and subsequent design and performance of further audit procedures.

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<sup>1</sup> International Standard on Auditing 500 – Audit Evidence

<sup>2</sup> International Standard on Auditing 500 – Audit Evidence, paragraphs 15 and A20-A24

- The explicit acknowledgement of the spectrum of inherent risk in ED-315 which has the potential for significant improvement in achieving consistency in the identification and assessment of the risk of material misstatement.
- The approach taken by the IAASB to enhance ED-315 in relation to automated tools and techniques, including data analytics, through the use of examples. The broader phrase automated tools and techniques recognises evolving technologies collectively and is inclusive of data analytics.

Our detailed responses to each of the IAASB's consultation questions, including any further enhancements we propose, are set out in Appendix 1. We have also included some editorial suggestions in Appendix 2. If you have any questions about our response or wish to discuss any of our observations in more detail please contact Josephine Jackson, Technical Director on [j.jackson@frc.org.uk](mailto:j.jackson@frc.org.uk) or +44 207 492 2473.

Yours sincerely



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### Responses to IAASB Consultation 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)?*

Overall the proposed changes help with the understandability of the risk identification and assessment process. The flowcharts are helpful in providing a visual depiction as to how ED-315 should be applied and in illustrating the iterative nature of ED-315. On finalising the standard, we recommend that the IAASB include the flowcharts in the Basis for Conclusions document, or alternatively a supplementary 'staff guidance' document.

*(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?*

We believe the revisions have the potential to deliver significant improvements to the identification and assessment of the risks of material misstatement informed by a more thorough understanding of the entity, its environment and its internal control. We agree that the revisions appropriately address the public interest issues outlined in paragraphs 6-28 of the explanatory memorandum.

*(c) Are the new introductory paragraphs helpful?*

We support the inclusion of the introductory paragraphs. We agree that they are helpful in facilitating auditors understanding of the important linkage between ED-315 and the foundational concepts of audit set out in ISA 200. In addition, providing a summary of the flow of the auditor's risk assessment process demonstrates the iterative nature of the process and overall context for the structure of the standard.

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?*

The requirements and application material of ED-315 are sufficiently clear and capable of proportionate application to the audits of financial statements for all entities, ranging from small, simple non-complex entities to large, complex, multinational entities.

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 by the IAASB to enhance ED-315 in relation to automated tools and techniques, including data analytics, through the use of examples. We also agree

that the examples provided in the application material are sufficiently comprehensive in clarifying in what circumstances the auditor might use automated tools and techniques.

We support the IAASB's decision to avoid prescriptive requirements about *how* audit evidence is obtained through automated tools and techniques. Detailed requirements that focus on specific technological advancements, such as data analytics, would lack the necessary flexibility to be adaptable to changing circumstances and may inhibit innovation. We also agree that the use of such automated tools and techniques have greater implications for other ISAs, such as those related to audit evidence, particularly ISA 500.

We strongly agree with the IAASB's decision to use the broader phrase 'automated tools and techniques' to recognise evolving technologies collectively, inclusive of data analytics.

- 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 agree with the approach being taken by the IAASB in ED-315 to emphasise the importance of professional scepticism in the introduction to standard, and to establish application material that is intended to drive sceptical behaviour. In particular, we support doing so by highlighting specific examples where the engagement team have an opportunity to exercise professional skepticism in the identification and assessment of risks. Simply inserting in the requirements further reminders to "apply professional scepticism" would not be sufficient in supporting behavioural change.

As highlighted in our introductory remarks, we also strongly agree that the proposed change to ISA 315 paragraph 17 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, is an important enhancement in further encouraging the exercise of professional skepticism.

- 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 of 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 support the enhancements to the requirements and application material related to the auditor's understanding of each component of the system of internal control and believe they have been appropriately enhanced and clarified. We agree with the IAASB's enhancements that clarify:

- That the scope of the auditor's understanding of internal control is of *all* components of the entity's system of internal control relevant to financial reporting.

- The nature of each component, such that three components consist primarily of ‘indirect controls’ and two components consist of primarily ‘direct controls’, and the updated terms used to describe aspects of the entity’s system of internal control (as explained in paragraph 33 of the explanatory memorandum).
  - Specific matters relating to each component that need to be understood.
- 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?*

Overall, we support the enhancements to the requirements and application material related to the auditor’s identification of controls relevant to the audit. However, we believe that information system controls are always ‘controls relevant to the audit’ because:

- Controls (i.e. policies and procedures) that define the flows of information relevant to financial reporting (information system controls) are always relevant to an audit of financial statements.
- The auditor is required to evaluate whether the information system controls are designed effectively and determine whether the controls have been implemented in accordance with ED-315 paragraph 36. Only when controls are relevant to the audit is the auditor required to evaluate the design and implementation of controls (in accordance with ED-315 paragraph 42).

Although the requirement in ED-315 paragraph 36, along with related application material, implies that information system controls are also ‘controls relevant to the audit’, we are concerned that excluding ‘information system controls’ from the list of ‘controls relevant to the audit’, set out in ED-315 paragraphs 39(a)-(e) is confusing. This ambiguity may result in information system controls not being tested sufficiently, and undue reliance being placed upon them. As a result, we believe that the IAASB should include information system controls in the comprehensive list of controls relevant to the audit in ED-315 paragraph 39.

- 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?*

Recognising that inspection findings by audit regulatory bodies and audit oversight bodies have consistently highlighted issues with respect to auditors’ understanding of internal control and consideration of IT risk, we strongly support the introduction of the new IT-related concepts and definitions, along with the enhanced requirements and much of the application material. The material better reflects the current IT environment and is sufficiently principles-based to allow for changing circumstances.

However, we suggest that relocating some of the application material to a dedicated appendix would be beneficial in reducing the length of the application material overall. For example, the lists of material in ED-315 paragraphs A145, A148, A149 and other paragraphs such as A180 and A183-A187 as appropriate.

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 agree strongly with the introduction of the separate assessments of inherent risk and control risk at the assertion level and believe the revised requirements and guidance are sufficiently comprehensive to support the separate assessments. The separate assessments of inherent and control risk at the assertion level, have the potential to drive significant improvements in the auditor's risk assessment process and subsequent design and performance of further audit procedures through:

- Driving a greater understanding of the interaction of ED-315 with ISA 330 (Revised). In particular, to address the assessed risks identified by the procedures in ISA 315 (Revised), ISA 330 paragraph 7 of requires the auditor to consider the reasons for the assessment given to the risk of material misstatement at the assertion level *separately* for inherent risk and control risk in order to design appropriate audit procedures to be performed to respond to the assessed risks.
- Combined with the introduction of inherent risk factors and the placement of inherent risks on the spectrum of inherent risks, supporting an enhanced understanding of the underlying reasons for the risk assessments which is critical to tailoring further audit procedures so that they are responsive to the risk.
- Addressing the challenge noted in the ISA 315 (Revised) IAASB Project Proposal (project proposal) that auditors find it confusing that whilst ISA 200 paragraph A40 states that the combined assessments of inherent risk and control risk may be performed, inherent risk by definition is assessed, and significant risks identified, before the consideration of any related controls. We understand from the project proposal, that because of this ambiguity some auditors find it challenging in practice to not allow the overall knowledge of internal control to influence the auditor's assessment of inherent risk. The consequence of this may be an assumed operating effectiveness of controls when assessing inherent risk, potentially resulting in a lower than appropriate assessment of the risk of material misstatement and an insufficient audit response.

b) *Do you support the introduction of the concepts and definition 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?*

As noted in our response to the IAASB's consultation on ED-540<sup>3</sup>, we strongly agree with the introduction of the concepts and definition of 'inherent risk factors'. We believe this material is essential to facilitating a robust risk assessment and audit response.

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)*

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<sup>3</sup> Exposure Draft — Proposed International Standard on Auditing 540 (Revised): Auditing Accounting Estimates and Related Disclosures

*assist in achieving greater consistency in the identification and assessment of the risk of material misstatement including significant risk?*

We strongly support the more explicit acknowledgement of this concept in ED-315 (i.e. enhancing that already briefly described in ISA 200<sup>4</sup>). It has the potential for significant improvement in achieving consistency in the identification and assessment of the risk of material misstatement. It should also address the matter raised in the project proposal regarding the potential over-emphasis of work effort in relation to significant risks at the expense of those risks of material misstatement that are not determined to be a significant risk<sup>5</sup>. As noted earlier, a greater understanding of the spectrum of inherent risk will also help auditors tailor further audit procedures more effectively.

*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., and 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 (significant COTABD) and relevant assertions and believe there is sufficient guidance to explain how they are determined. This concept, in our view, along with the concept of inherent risk factors, should facilitate the auditor in more effectively linking the inherent risks (identified through the auditor's understanding of the applicable financial reporting framework and the entity and its environment) to relevant assertions.

We recognise the challenge the IAASB has in writing ISAs in a linear manner when many aspects of ED-315 are interconnected in nature and are often performed in an iterative manner. However, despite this, we believe the requirements in relation to the determination of significant COTABD are missing an important and logical link. We agree with the placement of the auditor's final determination of significant COTABD in ED-315 paragraph 46. However, we believe it is important to make an explicit reference to the auditor's *initial expectation* about significant COTABD earlier in the requirements, specifically relating to the auditor's understanding of the entity and its environment and the applicable financial reporting framework in ED-315 paragraphs 23-24.

Without the understanding required in ED-315 paragraphs 23-24 and an initial determination of significant COTABD, it may be difficult for auditors to focus their attention effectively when performing the requirement in ED-315 paragraph 35(b) that addresses how information relating to significant COTABD flows through the entity's information system. We therefore recommend that the IAASB include a requirement for the auditor to make an initial determination of significant COTABD in the section of ED-315 addressing the auditor's understanding of the entity and its environment and the applicable financial reporting framework.

*e) Do you support the revised definition, and related material, on the determination of significant risk? What are your views on the matters presented in paragraph 57 of the*

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<sup>4</sup> ISA 200 paragraph A40 explains that Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others.

<sup>5</sup> ISA 315 (Revised) – IAASB Project Proposal. Paragraph 45

*Explanatory Memorandum relating to how significant risks are determined on the spectrum of inherent risk?*

We support the revised definition of significant risk and the related material. We are aware that in practice auditors have not always been consistent in determining which risks of material misstatement are “significant risks”, because the definition of such risks did not describe their nature but rather their implication for the audit (i.e., ‘requires special audit consideration’). The revised definition has significant potential for improving 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?*

We support the additional guidance related to the auditor’s identification and assessment of risks of material misstatement at the financial statement level. We also agree with the IAASB that the additional guidance has clarified the relationship between financial statement level risks and risks of material misstatement at the assertion level. In addition, in combination with the enhancements to the guidance related to the auditor’s understanding of the entity’s system of internal control (particularly ‘indirect controls’) we believe that the relationship between the components of internal control and financial statement level risks is clearer.

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 support the proposed stand-back requirement in ED-315 and the alignment with paragraph 18 of ISA 330. Paragraph 52 in our view supports the IAASB’s objective of enhancing and providing for a more robust risk assessment process. However, we do not agree that ED-315 paragraph 52 and ISA 330 paragraph 18 serve the same purpose and strongly believe that both requirements should be retained.

As noted in the explanatory memorandum, paragraph 52 requires an evaluation of the completeness of the significant classes of transactions, account balances and disclosures identified by the auditor and in turn the completeness of the identification of the risks of material misstatement.

In contrast, ISA 330 paragraph 18 recognises that regardless of the robustness of the auditor’s risk assessment process, there are always inherent limitations. Firstly, the auditor’s identification and assessment of risk is subject to judgement and secondly there are inherent limitations to internal control. In our view, paragraph 52 alone is not sufficient to recognise these inherent limitations, and therefore we would strongly oppose the removal of paragraph 18 of ISA 330.

### *Conforming Amendments*

We support the proposed conforming amendments described in Appendix 2 of the explanatory memorandum. However, we note that the revision of ISA 330 was not explicitly mentioned in the recently proposed ‘strategic direction for the IAASB’s Strategy for 2020–2023’<sup>6</sup>. We believe

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<sup>6</sup> [http://www.iaasb.org/system/files/meetings/files/20180917\\_IAASB-Agenda\\_Item\\_3-IAASB\\_Future\\_Strategy.pdf](http://www.iaasb.org/system/files/meetings/files/20180917_IAASB-Agenda_Item_3-IAASB_Future_Strategy.pdf)

it is very important for the IAASB to carefully consider whether the revisions to ED-315 (such as inherent risk factors and the spectrum of inherent risk) have implications for the revision of the requirements in ISA 330 to design and perform further audit procedures that are effective in addressing the identified and assessed risks. In particular, it is important to consider whether the requirements in ISA 330 are aligned with the revised concepts in ISA 315 and use consistent terminology. We therefore encourage the IAASB to include a research project to determine if further amendments to ISA 330 are necessary as a result of the revisions to ED-315.

Editorial Suggestions

| Paragraph or other reference | Comment/Editorial  |
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|                              | <b>ED-315</b>  |
| 27(c) and 27(d)              | <p>27(c) Establishes with the oversight of those charged with governance structure, reporting lines and appropriate authorities and responsibilities in pursuit of <del>its</del> <u>the entity's</u> objectives</p> <p>27(d) Demonstrates a commitment to attract, develop, and retain competent individuals in alignment with <del>its</del> <u>the entity's</u> objectives; and</p>   |
| 38                           | 38 The auditor shall obtain an understanding of the control activities component by identifying the controls relevant to the audit <del>in the control activities component</del> in accordance with the requirements of paragraphs 39-41, and by evaluating their design and determining whether they have been implemented in accordance with paragraph 42.  |
| 39                           | The hanging paragraph below 39(e) is not correctly aligned to paragraph 39.  |
| 41(b)                        | In respect of our response to Question 5(b) regarding information system controls, we note that ED-315 paragraph 41(b) implies general IT controls are also controls that are relevant to the audit, and paragraph 42 confirms this. We urge the IAASB to include general IT controls in the comprehensive list of <i>controls relevant to the audit</i> in ED-315 paragraphs 39(a) to (e) with appropriate cross-reference to paragraph 41.   |
| 45(b)                        | <p>In order to improve the link in the requirements and the application material between the auditor's identification of inherent risk factors in ED-315 paragraph 23(b)(i) and the identification of risks of material misstatement at the assertion level in paragraph 45(b), we suggest the following editorials:</p> <p>45. The auditor shall identify the risks of material misstatement and determine whether they exist at: (Ref: Para. A201–A210)</p> <p>(a) The financial statement level, by evaluating whether the identified risks relate more pervasively to the financial statements as a whole, including potentially affecting many assertions; or (Ref: Para. A207)</p> |

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|                 | <p>(b) The assertion level for classes of transactions, account balances, and disclosures, taking into account the <u>identified</u> inherent risk factors. (Ref. Para. A208-<u>A209</u>)</p> <p>A209. While obtaining the understanding as required by paragraph 23, the auditor <del>takes into account</del> <u>obtains an understanding of how the applicable financial reporting framework applies in the context of the nature and circumstances of the entity and its environment, including how events or conditions are subject to, or affected by the</u> inherent risk factors. Appendix 2 sets out examples, in the context of the inherent risk factors, of events and conditions that may indicate susceptibility to misstatement that may be material (<u>see paragraph A83</u>).</p>   |
| 50(a) and 50(b) | <p>We agree with the premise of paragraphs 50(a) and 50(b), that the auditor’s intention to rely on the operating effectiveness of controls, is determined through the auditor’s evaluation of whether the control is designed effectively and has been implemented (‘design and implementation’).</p> <p>However, we are concerned that</p> <ul style="list-style-type: none"> <li>• the emphasis in the first lines of these requirements are in respect of <i>further audit procedures</i>, (i.e. a topic addressed in ISA 330) and not in respect of the auditor’s risk assessment activities, which may cause confusion; and</li> <li>• the phraseology “take into account” in the second sentence of 50(a) implies that the auditor’s evaluation of design and implementation, and expected operating effectiveness could be dismissed or ignored in the auditor’s determination of control risk (or their decision to rely on the operating effectiveness of controls)</li> </ul> <p>We suggest the following alternative wording:</p> <p>50. For identified risks of material misstatement at the assertion level, the auditor shall assess control risk as follows: (Ref: Para. A232–A235)</p> <p>(a) <del>When the auditor plans to test the operating effectiveness of controls in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level,</del> The auditor shall assess control risk at less than maximum <u>when the auditor intends to rely on the operating effectiveness of controls. The auditor’s intended reliance shall be</u> <del>In doing so, the auditor shall take into account whether</del> <u>based on</u> the auditor’s evaluation of the design, implementation and expected operating effectiveness of such controls. <del>support the auditor’s intended reliance thereon.</del></p> |

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|              | <p>(b) <del>The auditor shall assess control risk at the maximum, When the auditor does not plan to test the intend to rely on the</del> operating effectiveness of controls <del>in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level,</del></p> <p>We also suggest that the application material supporting these requirements should make reference to paragraphs 7(a)(ii) and 8(a) and (b) of ISA 330, to draw the link between the auditor's determination of control risk in ED-315 and designing further auditor procedures to be performed in ISA 330.</p> |
| A233         | Using the same terminology 'maximum' in the example in A233, and not alternative terms (e.g. 'High' control risk), implies that setting control risk at maximum when the auditor does not plan to test the operating effectiveness of controls is optional. We suggest that the IAASB delete the example in the last two sentences of A233, or use an example that demonstrates what alternative terms might be used.  |
| A18          | A18. Some of the information used by the auditor... <del>In performing risk assessment procedures.</del> † The auditor may use automated tools and techniques in performing the risk assessment procedures, including for analysis, recalculations, reperformance or reconciliations   |
| A45          | A45. .. while delegating discussion with others, while taking into account <del>of</del> the extent of communication considered necessary throughout the engagement team...  |
| A223         | We believe this guidance is already addressed, and with more clarity, in A222 and suggest deleting A223  |
| A232         | A232 The auditor's intention to test the operating effectiveness of controls provides the basis for the auditor's assessment of control risk. In assessing control risk, the auditor takes into account the expectation about the operating effectiveness of controls <del>which is</del> (based on the auditor's evaluation of the design effectiveness and implementation of the controls. set out in paragraph 42.)   |
| Footnote 110 | Delete footnote 110. This footnote reference is to paragraph 102, the requirements in ED-315 only reach 52.  |
|              | <b>Conforming Amendments to ISA 540</b>  |
| 540.A10      | We suggest that for consistency, the conforming amendment to ISA 540 paragraph A10 should be aligned with ED-315 paragraph A232. We suggest deleting ISA 540 A10 and replacing it with the paragraph shown below. Please also note the further amendment to the paragraph below to take account of our suggested changes to A232 of ED-315 described above.  |

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|  | <p><i>Control Risk</i> (Ref: Para. 6)</p> <p>A10 The auditor's intention to test the operating effectiveness of controls provides the basis for the auditor's assessment of control risk. In assessing control risk, the auditor takes into account the expectation about the operating effectiveness of controls <u>which is</u> <del>(based on the auditor's evaluation of the design effectiveness and implementation of the controls. set out in paragraph 42)</del></p> |
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