

January 2020

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# CONSULTATION & IMPACT ASSESSMENT

## PROPOSAL TO REVISE ISA (UK) 315 (REVISED JUNE 2016):

### Identifying and Assessing the Risks of Material Misstatement through Understanding of the Entity and its Environment

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# CONSULTATION PAPER AND IMPACT ASSESSMENT

## Proposal to revise ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*

### Objective

The Financial Reporting Council (FRC) proposes, subject to consultation, to issue a revised version of International Standard on Auditing (UK) (ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, to reflect recent revisions to the international standards on auditing issued by the International Auditing and Assurance Standards Board (IAASB<sup>1</sup>). The revisions made by the IAASB are designed to establish a more robust and consistent risk identification and assessment. A more robust risk assessment process enhances the basis upon which auditors design and perform audit procedures that are responsive to the risks of material misstatement and, thereby, obtain sufficient appropriate audit evidence to provide a basis for the audit opinion.

As the ISA (UK) is being updated to reflect changes made at the international level, and we are satisfied that the revised standard has been amended in a way that sufficiently addresses matters raised by the FRC in its comment letter<sup>2</sup> on the IAASB's Exposure Draft, the FRC is not proposing to add any new UK requirements. As a result, we are able to confirm in the attached impact assessment that no additional work effort, beyond that which may be required by changes in the international standard, is expected to result from regulatory decisions taken by the FRC. In issuing the revised standard for consultation, the FRC has carried over the small amount supplementary material added to ISA (UK) 315 (Revised June 2016), which clarifies who are 'those charged with governance' in a UK context and identifies that they are the appropriate persons to provide critical written representations in line with ISA (UK) 580, *Written Representations*.

### Invitation to comment

The FRC is requesting comments on this Consultation Paper by 5pm on Friday, 3 April 2020. Comments are invited in writing on all aspects of the Consultation Paper. In particular, comments are sought in relation to questions 1-3 as discussed below.

Comments on the Consultation Paper should be sent to:

Keith Billing  
Project Director  
Financial Reporting Council  
E-mail: [AAT@frc.org.uk](mailto:AAT@frc.org.uk)

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<sup>1</sup> IAASB is a committee of the International Federation of Accountants (IFAC). The IAASB's constitution and due process is described in its 'Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements'.

<sup>2</sup> [https://www.frc.org.uk/getattachment/72175e81-948f-4aea-b232-3c11a9016d0c/FRC-Response-to-IAASB-Exposure-Draft-Proposed-ISA-315-Revised-\(Nov-2018\).pdf](https://www.frc.org.uk/getattachment/72175e81-948f-4aea-b232-3c11a9016d0c/FRC-Response-to-IAASB-Exposure-Draft-Proposed-ISA-315-Revised-(Nov-2018).pdf)

## Introduction

1. The Financial Reporting Council (FRC) is committed to acting as a proportionate and principles-based regulator, and balances the need to minimise the impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work, to maintain investor and wider stakeholder confidence in audit.
2. The ISAs (UK) are based on the corresponding international standards issued by the IAASB. Where necessary, the international standards have been augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context.
3. On 19 December 2019, the IAASB issued ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement* and related conforming amendments to other ISAs. The effective date of the revised and amended standards is for audits of financial statements for accounting periods beginning on or after 15 December 2021.
4. The FRC strongly supports the revisions and related amendments, noting their importance in supporting a more robust and consistent risk identification and assessment. The FRC believes that they represent an improvement to the current standards and they are also designed to address concerns expressed by regulators and other stakeholders. The revisions include:
  - Modernising and updating the standard for an evolving business environment. This includes requiring the auditor to understand the entity's use of IT in its business, the related risks and the system of internal control addressing such risks. The related application material has also been significantly enhanced. There is a clear delineation between the respective work efforts for understanding the IT environment as part of the understanding of the information system and the requirements to identify and address risks arising from the use of IT related to the IT applications and other aspects of the IT environment.
  - Taking account of the increasing use of automated tools and techniques by some auditors. There are no specific requirements to use these, reflecting that they are ways that procedures may be carried out but are not necessarily the only ways, but specific application material has been added to give examples of where and how they may be used.
  - Provisions designed to enhance the use of professional scepticism throughout the risk assessment process, including:
    - Emphasising in the introductory paragraphs the importance of applying professional scepticism.
    - Emphasising the need to not bias the auditor's work toward obtaining evidence that is corroborative or excluding evidence that is contradictory.
    - Introducing a new requirement for the auditor, towards the end of the risk assessment process, to consider all audit evidence obtained from performing risk assessment procedures, whether corroborative or contradictory, (to evaluate whether the audit evidence obtained from the risk assessment procedures provides

an appropriate basis for the identification and assessment of the risks of material misstatement).

More explicit language and enhanced application material has also been used to reinforce the importance of applying professional scepticism as appropriate.

- Clarifying that the purpose of performing risk assessment procedures is to obtain audit evidence that provides an appropriate basis for the identification and assessment of the risks of material misstatement and the design of further audit procedures in accordance with ISA (UK) 330 (Revised July 2017).
- Restructuring the requirement that focuses on the understanding of the entity and its environment, including to elevate the importance of understanding the applicable financial reporting framework.
- Introducing the concept of 'inherent risk factors' to assist the auditor in identifying events or conditions that may affect the susceptibility of assertions about classes of transactions, account balances or disclosures to misstatement.
- Enhancing and clarifying the requirements and application material pertaining to the auditor obtaining an understanding of the entity's system of internal control, including clarifying the controls for which the design is required to be evaluated and implementation determined. To aid understandability, the required understanding for each element of the system of internal control is presented in a tabular format.
- Enhancing and clarifying the requirements and application material pertaining to identifying and assessing the risks of material misstatement, including:
  - Introducing new concepts and/or definitions for:
    - Inherent risk factors (see above).
    - Relevant assertions - when the assertion about a class of transactions, account balance or disclosure has an identified risk of material misstatement.
    - Significant class of transactions, account balance or disclosure – those for which there is one or more relevant assertions.
    - Spectrum of inherent risk – the degree to which inherent risk varies. Application material explains how this should be operationalised.
    - Significant risk – an identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or that is to be treated as a significant risk in accordance with the requirements of other ISAs.
  - Explaining how control risk is assessed when the auditor does not plan to test the operating effectiveness of controls.

- Introducing a stand-back requirement to drive the completeness of the identification of the risks of material misstatement by evaluating the completeness of the significant classes of transactions, account balances and disclosures identified by the auditor.
  - Enhanced documentation requirements for the auditor's work in evaluating the design of controls and determining whether those controls have been implemented.
  - Enhanced application material giving examples of areas that may be documented to help demonstrate the exercise of professional scepticism.
5. Proposed conforming amendments to other ISAs (UK), reflecting those made by the IAASB to the corresponding international standards, are shown in mark-up in the exposure draft. These include:

ISA (UK) 200 (Revised June 2016), *Overall objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. Enhanced application material in relation to risks of material misstatement, including reference to inherent risk factors and the spectrum of inherent risk. Added references to considerations in relation to scalability and automated tools and tools and techniques.

ISA (UK) 210 (Revised June 2016), *Agreeing the Terms of Audit Engagements*. Minor conforming edits in the application material.

ISA (UK) 230 (Revised June 2016), *Audit Documentation*. Clarifying that examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control.

ISA (UK) 240 (Revised June 2016), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. Identifying that ISA (UK) 315 (Revised 2020) requires understanding of the applicable financial reporting framework and the system of internal control. Requiring that the auditor evaluate the design of controls that address risks of material misstatement due to fraud and determines whether they have been implemented. Requiring documentation of identified controls in the control activities component that address assessed risks of material misstatement due to fraud. Enhanced and edited application material, including for fraud risk factors.

ISA (UK) 250 Section A (Revised November 2019), *Consideration of Laws and Regulations in an Audit of Financial Statements*. Minor conforming edits in the application material.

ISA (UK) 260 (Revised November 2019), *Communication with Those Charged with Governance*. Minor conforming edits in the application material, including to conform references to matters that were determined to be 'significant risks' and to the entity's system of internal control.

ISA (UK) 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance*. Minor conforming edits, including to conform references to the entity's system of internal control.

ISA (UK) 300 (Revised June 2016), *Planning an Audit of Financial Statements*. Minor conforming edits in the application material.

ISA (UK) 330 (Revised July 2017), *The Auditor's responses to Assessed Risks*. Conforming edits and enhancements to the requirements and application material. These include clarifying that the auditor need not design and perform further audit procedures where the assessment of the risk of material misstatement is below the acceptably low level; enhanced application material in relation to general IT controls; enhanced application material in relation to when substantive procedures are required to be designed and performed.

ISA (UK) 402, *Audit Considerations Relating to an Entity Using a Service Organization*. Enhanced and clarified description of the scope of the standard. Enhanced and clarified objective. Conformed references to controls, and requiring that the auditor evaluate the design of controls in the controls activities component and determine whether they have been implemented. Conforming edits to the application material.

ISA (UK) 500, *Audit Evidence*. Minor conforming edits in the application material.

ISA (UK) 501, *Audit Evidence—Special Considerations for Selected Items*. Minor conforming edits in the application material.

ISA (UK) 530, *Audit Documentation*. Minor conforming edits in the application material.

ISA (UK) 540 (Revised December 2018), *Auditing Accounting Estimates and Related Disclosures*. Conforming edits in the requirements and application material, including in relation to references to the applicable financial reporting framework, inherent risk factors, the entity's information system, controls and IT applications.

ISA (UK) 550, *Related Parties*. Minor conforming edits in the application material.

ISA (UK) 600 (Revised November 2019), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*. Minor conforming edits in the requirements and application material, including to refer to understanding the applicable financial reporting framework and system of internal control.

ISA (UK) 610 (Revised June 2013), *Using the Work of Internal Auditors*. Minor conforming edits, including to refer to understanding the applicable financial reporting framework and system of internal control. Identifying that significant risks are risks assessed close to the upper end of the spectrum of inherent risk.

ISA (UK) 620 (Revised November 2019), *Using the Work of an Auditor's Expert*. Minor conforming edits in the application material.

ISA (UK) 701 (Revised November 2019), *Communicating Key Audit Matters in the Independent Auditor's Report*. Conforming edit in the application material to identify that a significant risk is an identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which the inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur.

ISA (UK) 720 (Revised November 2019), *The Auditor's Responsibilities Relating to Other Information*. Minor conforming edits in the application material relating to matters the auditor obtains an understanding of in line with ISA (UK) 315 (Revised 2020).

6. The FRC response<sup>3</sup> to the IAASB's consultation on the revised standard was strongly supportive of the aims of the IAASB. It identified several proposals the FRC was particularly supportive of and would want to be retained in the final standard. The response did not raise any significant concerns, but it did identify some areas where the FRC believed that the proposals could be further enhanced. The FRC is satisfied that the changes made by the IAASB in finalising the revised standard are appropriate and that ISA (UK) 315 (Revised June 2016) can be revised to adopt it without the need for further FRC supplementary material. It is proposed to retain the small amount of supplementary material, in the form of two footnotes, included in the current ISA (UK) 315 (Revised June 2016) as it clarifies who are 'those charged with governance' in a UK context and identifies they are the appropriate persons to provide critical written representations in line with ISA (UK) 580, *Written Representations*.
7. Consequently, the FRC proposes, subject to consultation, to issue a revised version of ISA (UK) 315, adopting the changes made by the IAASB to ISA 315 and the conforming amendments to other ISAs. This will ensure that the UK auditing standards continue to be compliant with the ISAs and maintains the FRC's support for the international harmonisation of auditing standards based on ISAs.

**Q1. Do you agree that ISA (UK) 315 (Revised June 2016) and other ISAs (UK) should be revised to adopt the revisions to the underlying international standard and the related conforming amendments to other ISAs? If not, please give your reasons and explain what action, if any, that you believe should be taken to update the ISAs (UK) in relation to identifying and assessing the risks of material misstatement.**

**Q2. If you agree that the ISAs (UK) should be revised to adopt the revised ISA 315 and conforming amendments, do you agree that the UK supplementary material can be limited to that shown in the exposure draft? If not, please give your reasons and explain what supplementary material, if any, you believe should be added.**

**Q3. Is the proposed effective date (audits of financial statements for accounting periods beginning on or after 15 December 2021), which is consistent with the effective date of the IAASB's revised ISAs, appropriate? If not, please give reasons and indicate the effective date that you would consider appropriate.**

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<sup>3</sup> [https://www.frc.org.uk/getattachment/72175e81-948f-4aea-b232-3c11a9016d0c/FRC-Response-to-IAASB-Exposure-Draft-Proposed-ISA-315-Revised-\(Nov-2018\).pdf](https://www.frc.org.uk/getattachment/72175e81-948f-4aea-b232-3c11a9016d0c/FRC-Response-to-IAASB-Exposure-Draft-Proposed-ISA-315-Revised-(Nov-2018).pdf)

## **Impact Assessment**

As a matter of policy, the FRC's auditing standards are based on the corresponding international standards issued by the IAASB. Where necessary the international standards are augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context. We believe that ISA 315 (Revised 2019) introduces changes compared to the current ISA 315 that are appropriate and proportionate to address issues that have been identified since the current standard was issued.

We propose to maintain the FRC's supplementary footnotes from the current standard, which clarify who are 'those charged with governance' in a UK context and identifies they are the appropriate persons to provide critical written representations in line with ISA (UK) 580, *Written Representations*. This should not result in additional work effort.

The revised standard has been designed to be scalable. We believe that benefits in the public interest of enhancements to the quality of audit of accounting estimates and related disclosures, although not quantifiable, will outweigh the costs of changes that may be necessary to audit firms' methodologies.

**Financial Reporting Council**

**January 2020**



**Financial Reporting Council**

8th Floor  
125 London Wall  
London  
EC2Y 5AS

+44 (0)20 7492 2300

[www.frc.org.uk](http://www.frc.org.uk)