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Guide to ISA 315 (Revised): Identifying and Assessing the Risks of Material Misstatement

In July 2020 the Financial Reporting Council (FRC) published extensive revisions to the International Standard on Auditing (ISA) (UK) 315: *Identifying and Assessing the Risks of Material Misstatement.*

The revisions are effective for audits of financial statements for periods beginning on or after 15 December 2021. The changes were made by the International Auditing and Assurance Standards Board (IAASB) and adopted by the FRC in its UK version of the standard to address concerns about audit quality. The FRC consider the new standard to improve significantly on the old version, and that the revised standard is better designed to "meet the challenges of an evolving business environment and the needs of users and protect the public interest."

Changes for auditors

The revisions are comprehensive and require auditors to significantly revise their audit approach through the expansion and strengthening of requirements that determine the scope and content of the mandatory audit risk assessments which drive the design, scope and scale of the detailed audit work.

In summary, the main areas of the revisions are:

1. The introduction of five new inherent risk factors to aid the audit risk assessment: subjectivity, complexity, uncertainty, change, and susceptibility to misstatement due to management bias or fraud
2. The introduction of the concept of a spectrum of risk, at the higher end of which lie significant inherent risks
3. The requirement for auditors to assess inherent and control risks separately rather than a combined assessment as currently allowed. These changes to audit risk assessment processes are designed to drive a more thorough understanding of the risks faced by an entity and consequently a more appropriate risk assessment and tailored audit work.
4. The requirement for auditors to obtain a far deeper and wider understanding of the audited entity's IT environment and controls, particularly IT general controls. The need for this understanding is in part a response to the 'evolving business environment' identified by the FRC refer to in the quote in the introduction above.
5. A requirement for auditors to understand and document more about the systems and controls relevant to the audit and on the design and implementation work required for these controls
6. A requirement to distinguish between direct and indirect control components
7. As with recent revisions to other ISA's there is an increased focus on 'professional scepticism' – in particular the need not to bias work toward obtaining evidence that is corroborative or excluding evidence that is contradictory. It also introduces strengthened documentation requirements for auditors in this area.
8. The requirement for auditors to obtain 'sufficient, appropriate' evidence from risk assessment procedures as the basis for the risk assessment
9. A new 'stand-back' requirement which compels auditors to reconsider the audit implications, when material classes of transactions, account balances, and disclosures are not assessed as significant in the original assessment and to reconsider if the original assessment is appropriate

Changes to the annual audit

- The revisions to the standard that require auditors to perform separate inherent risk and control risk assessments, combined with the new inherent risk factors framework, will mean that auditors refresh their risk assessments of entities being audited. They must also seek to gain new, deeper insights about the most significant matters which could affect the audit.
- The new concept of the 'spectrum of inherent risk' will change how all risks are assessed. Where the assessed risk falls on the spectrum will determine the scope and extent of further procedures auditors will need to perform. The higher on the spectrum the risk falls, the more persuasive the audit evidence needs to be. Therefore, the spectrum of risk concept should drive improvements in the focus of audit work towards those areas which are susceptible to greater risk, while the changes to how audit evidence is to be assessed is anticipated to lead to better quality audit evidence.
- The requirement for auditors to obtain a far deeper and wider understanding of risks faced by the audited entity together with a greater understanding of its IT environment and controls will increase the time devoted to planning audits. Audit teams will spend more time completing risk assessment processes, performing more detailed audit planning, and will make new or more detailed enquiries and requests of management, operations, and IT teams in order to increase their understanding and meet the requirements of the new audit standard.
- The changes to audit evidence requirements build upon the concepts introduced with ISA 540 (Accounting Estimates) in 2019; auditors are likely to require more evidence across the audit, particularly those areas which are the most complex, subjective, or judgmental. When these changes are combined with the increased focus on the need for 'professional scepticism' in audit, management of audited entities are likely to find they are asked for greater quantities of, or more detailed, audit evidence during the audit process.

While meeting the requirements will increase the amount of audit team and management time spent on the audit, this deeper understanding of audited entities is anticipated to result in changes to the detailed audit approach and improve the quality of audits by ensuring that audit resources are increasingly focused on the most material risks faced by entities. Additionally, while the focus of the changes to the audit standard and required responses are designed to improve audit quality, we also anticipate that entities may often receive new or more detailed insight into control weaknesses as a result of the enhanced audit risk assessment and subsequent detailed audit work.

Conclusions

In their impact statement the FRC expected that, "benefits in the public interest of enhancements to the quality of audit through a more robust and consistent risk identification and assessment, although not quantifiable, will outweigh the costs of changes that may be necessary to audit firms' methodologies."

We concur with the FRC that the changes will enhance audit quality across all compliant UK audits, but the costs of compliance will be significant. The extent of the impact on different entities will likely reflect the scale and complexity of the audited entity, the risks it faces, and the scale and complexity of its control environment, including the extent of IT systems and controls in use. Due to the differing levels of impact on different entities, it can be hard to make generalisations about the likely impact on audit fees, but we estimate that audit fees will rise by between 5 - 20% to meet the new requirements imposed by ISA (UK) 315.

To meet the increased requirements of the new regulations in an efficient and timely manner, that minimises as much as possible the additional time and cost expected, auditors should liaise with management and finance teams early in the audit planning process to set out the impact of the new requirements on the audit plan and the necessary deliverables from management. The new processes for risk assessment and understanding the internal controls, including those over IT, are likely to involve staff at the audited entity from outside the finance function, particularly IT staff or service providers. These team members should be alerted to their probable involvement as soon as practicable.

At haysmacintyre, we are currently transitioning to new audit software that has early adopted the new documentation and risk assessment requirements of the new audit standard. This software, alongside other investments in technology such as in data analytics and file sharing software, will help us to maintain an efficient audit process and is hoped to minimise the time cost increases due to ISA (UK) 315. However, the new requirements are substantial and increases in audit time costs and consequently audit fees are expected. As above, we plan to work closely with our clients to ensure that they can provide the necessary new information and audit evidence on a timely manner to minimise, as much as possible, increases in audit time costs and fees.

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