The Japanese Institute of
Certified Public Accountants
4-4-1 Kudan-Minami, Chiyoda-ku, Tokyo 102-8264, Japan
Phone: 81-3-3515-1130 Fax: 81-3-5226-3355
Email: international@sec.jicpa.or.jp

November 7, 2018
Mr. Dan Montgomery
Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
529 5th Avenue, 6th Floor
New York, NY 10017 USA

Dear Mr. Montgomery,

Re: JICPA Response to the Proposed International Standard on Auditing 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*

The Japanese Institute of Certified Public Accountants (JICPA) is grateful for the opportunity to comment on the Proposed ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement* (ED-315) issued by the International Auditing and Assurance Standards Board.

The attached are our comments on matters that we consider to be addressed, including some of the questions in “Overall Questions” and “Request for Specific Comments.”

We hope that our views will be of assistance to the IAASB.

Sincerely yours,

Sayaka Sumida

Executive Board Member - Auditing Standards
The Japanese Institute of Certified Public Accountants

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

Identification and assessment of the risks of material misstatement is a foundation for the risk-based audit, and therefore ISA 315 is an important standard in ISAs. We broadly support the direction of the proposed changes, including the introduction of new concepts, as we find that those promote a more consistent and robust process of the identification and assessment of the risks of material misstatement.

Notwithstanding our overall support, we are concerned about the length and complexity of ED-315 as these may hinder the understandability of the conceptual flow of the proposed risk assessment process. Additionally, it is not clear what substantial changes were made to the extant ISA 315. Therefore, we believe overall structure of the standard should be reconsidered to enhance the understandability and applicability of the standard (refer to our comment on "Identifying controls relevant to the audit", question 5) below).

Although we find that the flowcharts are helpful to enhance the understandability of the standard, the standard should be as concise as possible. Therefore, we propose to publish the flowcharts as implementation support tools, separately from ISA 315 (Revised), with an explanation of the major changes from the extant ISA 315.

We find that the inclusion of the introductory paragraphs to highlight key concepts is generally helpful to promote the understandability of the whole picture of standard, however, the proposed introductory paragraphs seem to be a short list of some requirements, and do not clarify the key concepts or adequately describe the purpose of introducing new concepts. We propose that the introductory paragraphs should focus on clarifying the key concepts and explaining how the key concepts interact with one another. In particular, we encourage the IAASB to consider the following modifications:

- Paragraphs 2 and 3: These paragraphs are already included in ISA 200 and we believe that they are repetitive and therefore unnecessary.
- Paragraphs 4 through 8: We encourage the IAASB to revise these paragraphs as below:
  - The auditor is required to identify and assess the risks of material misstatement at the financial statement level and at the assertion level. While the risks of material misstatement at the financial statement level are assessed on a combined basis of inherent risk and control risk, the risks of material misstatement at the assertion level are assessed for inherent and control risk separately. The separate assessment of these risks enables the auditor to design and perform a more robust and appropriate risk responses.

- Risks of material misstatement in financial statements can arise from either fraud or error, and the auditor identifies and assesses risks of material misstatement due to fraud separately from those due to error. The risk assessment process is cumulative and risks due to both error and fraud are covered by ISA 315 (revised). Further requirements and guidance for the fraud risks are provided in ISA 240. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of financial statements is intentional or unintentional, which requires the auditor to consider different risk factors and different responses to the risks.

- Robust assessment of inherent risks is necessary to design and perform further audit procedures that are appropriate for responding to the risks of material misstatement at the assertion level. For this purpose, ISA 135 (revised) requires the following:
  - Inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. The degree to which inherent risk varies is referred to as the "spectrum of inherent risk." The auditor's assessment of inherent risk due to error which is close to the upper end of the spectrum of inherent risk results in significant risks, which require special audit considerations in other aspects of the audit (refer to our comments on question 6) e)).
  - Assertion is relevant when there is a reasonable possibility of occurrence of a misstatement with respect to an assertion that is material, individually or in combination with other misstatements. The determination of whether an assertion is a relevant assertion is made before consideration of controls, taking account of inherent risk factors. For identified risks of material misstatement at the assertion level, the auditor assesses inherent risk by assessing the likelihood and magnitude of material misstatement.
  - A class of transactions, account balances or disclosures where there is one or more relevant assertion is determined as a "significant class of transactions, account balances or disclosures." Based on the identification of significant classes of transactions, account balances or disclosures, the auditor understands the system of internal control, identifies "controls relevant to the audit" and assesses control risks (refer to our comments on question 5) b)).

- We suggest to emphasize the auditor's risk assessment process is iterative and dynamic (the first sentence in paragraph 9) and state that the order in which the requirements are applied may vary. We encourage the IAASB to consider whether the remaining sentences in paragraph 9, and paragraphs 10 through 12 are necessary to enhance understandability.
- We support that the introductory paragraphs mention scalability because of its importance. However, we encourage the IAASB to reconsider the description of scalability (refer to our comments on question 2)). We are concerned that ED-315 seems to suggest that if the entity falls under the category of "smaller and less complex entities", all guidance relating to the smaller and less complex entities are applicable to the audit. We suggest that the description of scalability should be modified and should state that consideration of how to apply requirements be made on a requirement-to-requirement basis in light of the aim of each requirement taking account of "the nature, size and complexity of the entity" (refer to our comments on paragraph A47, question 2)).

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?

We believe that the scalability of standards is one of the IAASB's challenges requiring strategic focus. ED-315 has removed the extant "considerations specific to smaller entities" sections throughout the standard, and has placed guidance relating to audits of "smaller and less complex entities." However, we consider that the scalability of standards should not be defined in ED-315 differently from other standards, without amending the relevant drafting convention in the extant ISA 200 "*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*." Additionally, paragraph A66 in ISA 200 describes the term "smaller entities," which is used throughout the other standards, and the term "smaller and less complex entities" contradicts A66 (b) in ISA 200 as A66 (b) includes less complex characteristics in its "small entities" definition. Furthermore, removing "considerations specific to smaller entities" sections makes it harder to identify the guidance for scalability in the lengthy ED-315.

We recognize that the IAASB is going to undertake a project of audits of less complex entities. Therefore, the scalability of standards should be considered as part of this project as this affects other standards, instead of determining the scalability in the respective standards.

In addition, we find that ED-315's approach to scalability has two challenges:

- First, scalability should not be addressed by the judgment as to whether an entity falls under the category of "smaller and less complex entities" (refer to our comments on question 1).
- Second, the auditor is required to have an understanding of the entire text of an ISA, and to determine and apply relevant requirements and application materials as appropriate for the circumstances of the audit in accordance with ISA 200. However, our concern is that the length and complexity of ED-315 makes the standard less understandable and makes it harder for the auditor to determine which requirements and application materials are relevant to the audit. We encourage the IAASB to reconsider whether the following paragraphs related to scalability promote the application of scalability as intended.

Paragraph Reference	Suggestions
A16 (Third and fourth sentences)	Based on the following reasons, we suggest removing the third and fourth sentences in A16. Paragraph 17 and the second sentence in A16 adequately describe the risk assessment procedures and suggest that the auditor's procedures to obtain an overall understanding may be less extensive in audits of smaller and less complex entities. As the third sentence only applies to the audit of smaller and less complex entities, the fourth sentence may lead to the misunderstanding that it applies to the audit of smaller and less complex entities only, and that the depth of the auditor's overall understanding is less than that possessed by management in managing the entity in auditing the smaller and less complex entities, whereas in fact the fourth sentence applies to the audit generally.

Paragraph Reference	Suggestions
	Additionally, the fourth sentence is the description of paragraph A3 in the extant ISA 315: “the depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.” This sentence appears to be unnecessary as it is impractical for the auditor to have more understanding of the entity than management.
A41 (Second sentence)	When the engagement is carried out by a single individual, it appears to be obvious that the requirements related to engagement team discussion are not relevant, and therefore paragraphs A42 and A43 are not applicable. We suggest eliminating the second sentence in A41 to shorten the standard.
A43 (First sentence)	The first sentence in paragraph A43 includes “even in circumstances where the applicable financial reporting framework only requires simplified disclosures.” This description does not enhance scalability and should be removed.
A47 (Last sentence)	The last sentence, “The nature and extent of the understanding required will likely depend on the nature, size and complexity of the entity,” is essential to the scalability consideration and we propose to move this sentence to the scalability section in the introductory paragraph.
A164	Paragraph A164 appears to apply to all smaller entities with fewer employees, and its application is not limited to “smaller and less complex entities.”
A224	We propose to remove this paragraph as paragraph A224 could lead to the misunderstanding that inherent risks would not be assessed as the higher end of the spectrum of inherent risk in auditing smaller and less complex 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 support that ED-315 provides examples of how the automated tools and techniques are being used, and that the standard does not define the term “data analytics.” In this regard, we propose to eliminate the second sentence in paragraph A33: “Applying automated analytical procedures to the data may be referred to as data analytics.” The term “data analytics” appears only in this sentence, and the reference to “data analytics” appears to contradict the proposal not to define the term. Additionally, because of the second sentence in paragraph A33, some readers may misunderstand that the term “a spreadsheet” in the third sentence refers to only “data analytics” due to the structure of this sentence.

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 do not support the change to paragraph 17. We are concerned that:

- The exercise of professional skepticism would not be enhanced merely by adding the phrase "sufficient appropriate audit evidence."
- The reference to the term "sufficient appropriate audit evidence" in paragraph 17 may lead to confusion about it may suggest "sufficient appropriate audit evidence" when evaluating audit evidence at the assertion level. The following sentence, "Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion," may also cause the same confusion.
- The phrase "…the (a) basis for …" is generally used in other paragraphs of ED-315 (e.g., paragraphs 15, 23, 47 and A47, A89, A108, A118 and A129), without mentioning "sufficient appropriate audit evidence." We understand that it is used to describe that the aim of the requirement is to obtain "the basis for" the next step in the audit process, which should also apply in paragraph 17. Therefore, we are concerned that the proposed change of paragraph 17 creates unintended inconsistency with the texts of other requirements.
- Paragraph 17 appears to be lengthy and complicated as it is structured as follows: "The auditor shall….<u>to obtain</u> an understanding of …<u>to obtain</u> sufficient appropriate audit evidence as the basis for…". Therefore, we propose the following revision:

> The auditor shall design and perform risk assessment procedures to obtain an understanding of:
> (a) The entity and its environment in accordance with paragraph 23(a);
> (b) The applicable financial reporting framework in accordance with paragraph 23(b); and
> (c) The entity's system of internal control in accordance with paragraphs 25–44
> ~~to obtain a sufficient appropriate audit evidence~~ as <u>an appropriate</u> basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

Specific Questions

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? 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? 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?

Comments on (a) and (b)

We support that ED-315 requires the auditor to obtain an understanding of five components of the entity's system of internal control. We also support classifying the components of internal control as "indirect controls" and "direct controls" based on the nature of components, as it would clarify the relationship between understanding the entity's system of internal control and the work effort of identifying and assessing the risks of material misstatement. Given the length of ED-315 and its complexity, we believe the flowcharts and additional supporting tools are essential to enhance the understandability of the standard.

Notwithstanding our overall support, we are concerned that:

- Indirect controls relevant to the audit

Paragraph A166 prescribes that "controls relevant to the audit are primarily direct controls and are primarily controls in the control activities component." Additionally, paragraph A104 explains that "controls relevant to the audit are likely to include mainly controls in the control activities component," but "controls relevant to the audit may also include controls in other components of the system of internal control." Moreover, paragraph A125 gives an example of direct controls in the entity's process to monitor the system of internal control: "monitoring activities, such as management or supervisory reviews, may be precise enough to address risks of material misstatement at the assertion level (i.e., direct controls)." Furthermore, paragraph A195 says that "often, only multiple controls, together with other components of the system of internal control, will be sufficient to address a risk of material misstatement," which suggests that all these controls may be identified as "control relevant to the audit" that require the D&I procedures.

With regard to these paragraphs, we believe a better clarification of the relationship between the direct /indirect controls and the controls relevant to the audit would enhance the understandability as it is not clearly described whether:

- Controls in the control environment, the entity's risk assessment process and the entity's process to monitor the system of internal control are classified as direct controls when such controls are identified as controls relevant to the audit. In other words, regardless of the components of internal control, only those controls that are precise enough to address risks of material misstatement at the assertion level (i.e., direct controls) are identified as controls relevant to the audit, and the auditor evaluates the design of those direct controls and determines the implementation.

  OR

- Classification of direct and indirect controls is introduced to assist identification of "control relevant to the audit" that address risks of material misstatements at the assertion level. Although controls relevant to the audit are primary direct controls, some indirect controls can be controls relevant to the audit.

Additionally, we propose that the IAASB should include examples of indirect controls which are identified as controls relevant to the audit other than general IT controls, which are identified in accordance with paragraph 41(b), in order to enhance understandability. Paragraph A197 describes that "Controls that support other controls are indirect controls. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements related to the risk of material misstatement." This description may cause some readers to interpret that no indirect controls are identified as controls relevant to the audit, and that the auditor is not required to evaluate the design and implementation of these controls. Therefore, we propose that ED-315 should clearly state that there can be circumstances where indirect controls, which support the effective functioning of other direct controls, can be identified as controls relevant to the audit. Such clarification would enhance the consistency with ISA 330, which describes that, for example, when the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, additional audit evidence may be obtained by testing the indirect controls.

- Audit procedures to obtain an understanding of the indirect controls

It would enhance the understandability and practicality of application of the standard if ED-315 provided clearer descriptions as to what audit procedures are to be performed in order to obtain an understanding and evaluation of the control environment, the entity's risk assessment process and the entity's process to monitor the system of internal control. Paragraph A20 states that "although the auditor is required to perform all the risk assessment procedures described in paragraph 18 in the course of obtaining the required understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control (see paragraphs 23–44), the auditor is not required to perform all of them for each aspect of that understanding." Additionally, paragraph A198 indicates that "risk assessment procedures to obtain audit evidence about the design and implementation of controls relevant to the audit" include inquiry and other risk assessment procedures. On the other hand, the second sentence in paragraph A108 explains that "the nature, timing and extent of the auditor's procedure to obtain the understanding of the control environment may vary to the extent necessary," which is followed by the third sentence which introduces an example where the auditor performs inquiry as well as observation and inspection. With regard to these paragraphs, it is not clear whether there could be a situation where the inquiry alone can be sufficient as one of the effective risk assessment procedures.

- Identifying controls relevant to the audit (paragraph 39)

Paragraph 39 lists the criteria of controls relevant to the audit. However, it appears to be unclear as to the linkage between the assessment of inherent risk and the identification of controls relevant to the audit due to the lack of description of the relationship between the controls relevant to the audit and the significant classes of transactions, account balances and disclosures. Paragraph 35 requires the auditor to obtain an understanding of the information system relating to significant classes of transactions, account balances and disclosures. It appears that the description of paragraph 39 does not balance out this paragraph. This may lead some readers to interpret that the auditor is required to obtain an understanding of controls related to not-significant classes of transactions, account balances and disclosures.

Significant risks, risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and significant classes of transactions, account balances or disclosures are all determined based on the assessment of inherent risk. Additionally, controls relevant to the audit are identified based on the determination of significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence. However, in the requirement section, the term "significant classes of transactions, account balances and disclosures" mentioned in paragraph 35 may give an impression to some readers that the term is introduced without appropriate explanation as the determination of significant classes of transactions, account balances and disclosures is described in the following paragraph 46 which states that "The auditor shall determine significant classes of transactions, account balances and disclosures, and their relevant assertions, based on the identified risks of material misstatement." Additionally, paragraph 35 is located before paragraphs 49 and 51 on the determination of significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence. The purposes of ED-315 include clarifying when controls are considered to be relevant to the audit, and determining the risk of material misstatement more consistently and effectively. To achieve these purposes, we believe that ED-315 should describe the risk assessment process in such a way that the identification of controls relevant to the audit generally comes after identification of significant classes of transactions, account balances or disclosures, and determination of significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, which are all based on the assessment of inherent risk.

Paragraph 49 in the explanatory memorandum in ED-315 describes that "the IAASB acknowledges that the order in which the requirements related to the identification of the risks of material misstatement are to be applied should not be prescribed." We understand that the IAASB's intent is to ensure flexibility in practice. However, we believe that ED-315 should be based on the conceptual flow of the auditor's risk assessment process. Flexibility can be explained in the application materials.

Therefore, we suggest that the requirements for the assessment of inherent risk, and also the determination of significant classes of transactions, account balances or disclosures, significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence should be moved before the requirements relating to obtaining an understanding of controls at the assertion level (i.e., before paragraph 35) or paragraph 25, which requires obtaining an understanding of the entity's system of internal control.

Comments on (c)

- Identification of risks arising from the use of IT and general IT controls relevant to the audit (paragraphs 40 and 41)

We believe that the proposals do not sufficiently clarify the identification of risks arising from the use of IT and the general IT controls relevant to the audit. Paragraph 40 states that the auditor shall identify the IT applications and other aspects of the entity’s IT environment that are relevant to the audit based on the understanding obtained in accordance with paragraph 35(d), and the identification of the controls relevant to the audit in accordance with paragraph 39. Also, paragraph 41 states that the auditor shall identify the risks arising from the use of IT and the general IT controls relevant to the audit for the IT applications and other aspects of the IT environment that are relevant to the audit.

However, the scope of the IT applications and other aspects of the entity’s IT environment that are relevant to the audit is not clear from the ED-315. The proposals seem to suggest that, if a risk arising from the use of IT exists but is not related to risks of material misstatement, the auditor is still required to evaluate the design and determine the implementation of general IT controls relevant to such a risk. Also, paragraph 4 (the entity’s risk assessment process) of Appendix 3 “Understanding the Entity's System of Internal Control” describes cybersecurity risks as risks relevant to reliable financial reporting arising from the use of IT. We are concerned that cybersecurity risks may be misunderstood as typical examples of risks arising from the use of IT. We believe it is necessary to clarify that the auditor identifies risks arising from the use of IT taking into account the likelihood and magnitude of misstatements, and that general IT controls relevant to audits are those only for relevant assertions.

In addition, paragraph 40(b) does not refer to the aspect of management reliance and auditor’s determination on the control which is not consistent with paragraph 40(a). In order to be consistent with paragraph 40(a) and the last sentence of paragraph A186, the following modifications should be made.

> (b) Maintenance of the integrity of information stored and processed in the information system ~~that~~ relating~~es~~ to significant class of transactions, account balances or disclosures that management is relying on and that the auditor has determined to be relevant to the audit”

- Definition of general IT controls (paragraph 16(e))

The current definition of IT general controls has been changed from “... by helping to ensure the continued proper operation of information system...” to “... by helping to maintain the continued operation, as designed, of the entity’s information system)....” It is unclear why “proper” was deleted and “as designed” was added.

- Relationship between the definition of the IT environment and the entity’s process to monitor the system of the internal control

According to the definition of general IT controls (paragraph 16(e)), general IT controls include controls over the entity’s IT processes. Also, according to the definition of the IT environment (paragraph 16(g)), the IT processes in the IT environment include “monitoring of the IT environment.” We believe that it is necessary to clarify the relationship between the controls in general IT controls, the monitoring of the IT environment included in the IT environment, and the entity’s process to monitor the system of internal control, which is a component of the system of internal control.

- Definition of “integrity of information”

The term “information integrity” is used in several paragraphs in ED-315. We propose that ED-315 should explain the meaning of “information integrity,” or define it, to clarify the relation with “accuracy” and “completeness” in assertions (paragraph A204).

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?

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?

c) In your view, will the introduction of the “spectrum of inherent risk” (and the related concepts of assessing 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?

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 exist?

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

Comments on (a) (separate assessments of inherent and control risk)

We support requiring separate assessments of inherent and control risk at the assertion level. However, we have the following comments.

- Identification of the risks of material misstatement (paragraphs 45 and 46)

In accordance with paragraph 45 of ED-315, the auditor is required to identify the risks of material misstatement at the assertion level before consideration of any controls, which are inherent risks. However, paragraph 13(n) of ISA 200 defines that a risk of material misstatement at the assertion level consists of inherent risk and control risk and indicates that it is a concept after consideration of any controls. Therefore, it is difficult to understand how the definitions and concepts in ISA 200 flow to those in ED-315. In order to maintain a consistency with ISA 200 definitions, we believe that at least the following clarification is necessary. Alternatively, as stated in our comments to Question 5), we believe the order of the requirements should be changed to require the auditor to identify and assess inherent risks first and then controls relating to the assessed inherent risk.

45. The auditor shall identify the risks of material misstatement and determine whether they exist at: (Ref: Para. A201-A210)
    (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

(b) The assertion level for classes of transactions, account balances, and disclosures, taking in account the inherent risk factors (i.e., identification of inherent risks).

46. The auditor shall determine significant classes of transactions, account balances and disclosures and their relevant assertions, based on the identified inherent risks ~~risks of material misstatement~~."

- Assessment of control risk (paragraphs 50 and A233)

We believe that it is necessary to clarify the meanings of "assess control risk at less than maximum" and "assess control risk at the maximum" (paragraph 50). We propose to add guidance in paragraph A233 explaining the impact on the assessment of risks of material misstatement. For example, guidance could clarify that the risk of material misstatement will be assessed as less than the assessed inherent risk if the auditor intends to rely on the operating effectiveness of controls, and the risk of material misstatement will remain as the assessed inherent risk if the auditor does not intend to rely on controls.

Comments on (b) (inherent risk factors)

We disagree with the proposal to include quantitative aspects in the definition of inherent risk factors. The assessment of inherent risks means the assessment of susceptibility to "material misstatement." Therefore, it is not necessary to include the monetary concept in inherent risk factors. Qualitative considerations are relatively important in risk assessment, and we believe that the explicit inclusion of quantitative aspects in inherent risk factors may dilute the importance of qualitative considerations. We understand that paragraph A6 is intended to provide examples including quantitative inherent risk factors. However, they are all qualitative, except for the first bullet. We also consider the first bullet to be inappropriate as it confuses the consideration of materiality.

We also think that the "susceptibility to misstatement due to management bias" and "susceptibility to misstatement due to fraud" should be separated. Fraud does not arise solely from management bias. In addition, consideration of fraud (including intentional management bias) is extremely important compared to consideration of unintentional management bias.

Comments on (c) (spectrum of inherent risk)

We agree with the proposal to introduce the concept of spectrum of inherent risk, and the related concepts of assessing likelihood of occurrence and magnitude of a possible misstatement. However, we believe that it is necessary to clarify that assessment of inherent risk is divided into those due to fraud and those due to error, and the concept of spectrum of inherent risk is mainly used to show the degree of risk due to error (see our related comments on (e) below).

Comments on (d) (Significant classes of transactions, account balances or disclosures)

We agree with the proposal to introduce the concept of significant classes of transactions, account balances or disclosures.

Comments on (e) (Significant risk)

We do not agree that the threshold for significant risk could be the likelihood or magnitude. If significant risks include not only the risks that meet the thresholds of the likelihood and magnitude, but also those with a high magnitude of potential misstatement but a low expectation of the risk occurring, we are concerned that the risk that should be most closely watched (i.e., the risk with a high likelihood of occurrence and a high magnitude of potential misstatement) may not be watched closely. We also believe that it is inconsistent with the concept of spectrum of inherent risk. We understand that the purpose of introducing the concept of spectrum of inherent risk is to encourage more robust risk assessment according to the nature of risk, to design and perform further audit procedures corresponding to each assessed risk. Further audit procedures for a risk that is less likely to occur but has a high magnitude should be appropriately designed according to the nature of such a risk, and therefore it should be different from the procedures designed for a risk with a high likelihood of occurrence and a high magnitude of potential misstatement, and therefore requires special audit consideration.

In addition, we propose the following changes.

- We propose that significant risk should be defined by risk due to error (the first bullet) and risk due to fraud (the second bullet) separately as follows. As footnote 83 indicates, the requirements to which the second bullet relates (i.e., paragraph 27 of ISA 240 and paragraph 18 of ISA 550) are all related to fraud risks. Risk factors differ between the risks due to errors and the risks due to fraud, and therefore the approaches to risk response also differ. We believe that distinguishing between them would lead to more accurate design and performance of further audit procedures. Furthermore, when a fraud risk is identified, the auditor is required to treat it as a significant risk, regardless of the degree of risk. Therefore, fraud risks clearly differ from risks due to errors.
- For clarity, we suggest adding “material” prior to “misstatement” of the first bullet. We believe the likelihood that a material misstatement will occur is different from the likelihood that a non-material misstatement will occur. Therefore, if the likelihood of a non-material misstatement is high but the likelihood of a material misstatement is not high, we believe it is not necessary to treat it as a significant risk.
- In addition to describing the nature of significant risks in the definition, the current definition (i.e., “a risk of material misstatement that, in the auditor’s judgment, requires special audit considerations”) should also be retained in the revised definition. The current definition provides an important message that the auditor is required to design further audit procedures that match the risk factors on which the risk assessment is based, which indicates the purpose of the requirement to determine significant risk. Therefore, we believe it must also be retained in the revised definition.

> Significant risk –An identified risk of material misstatement that, in the auditor’s judgment, requires special audit consideration. Significant risk includes:
>
> - For which the assessment of inherent risk due to error is close to the upper end of the spectrum of inherent risk due to the degree of which one or a combination of the inherent risk factors affect the likelihood of a material misstatement occurring and~~or~~ the magnitude of potential material misstatement should that misstatement occur; or
> - For which the assessed risk due to fraud t~~T~~hat is to be treated as a significant risk in accordance with the requirements of other ISAs.

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 inclusion of additional guidance in relation to the auditor's assessment of risks of material misstatement at the financial statement level. We have the following comments with respect to relevant application materials.

- Paragraphs A215 and A217 (Risks related to management override of controls)

In paragraph A215, the risk of management override of controls is illustrated as an example of the risk of material misstatement due to fraud at the financial statement level that cannot be associated with a particular assertion. Paragraph A217 also states that risks of material misstatement due to fraud may be relevant to the auditor's consideration of the risks of material misstatement at the financial statement level, and the risk of management override of controls is illustrated as an example.

ISA 240 states that, although the level of the risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Paragraphs A215 and A217 in ED-315 seem to indicate that a risk related to management override of controls is treated as a risk of material misstatement at the financial statement level in all audits, and therefore we are concerned that it may cause the misunderstanding that an overall response in accordance with paragraph 29 of ISA 240 is required for all audits.

We believe that it is necessary to clarify that the risks related to management override of controls may be determined as a fraud risk either at the assertion level, or at the financial statement level depending on the circumstances.

- The first sentence of paragraph A215

To be consistent with the second sentence, "more" should be deleted.

> Because risks of material misstatement at the financial statement level have a pervasive effect on the financial statements, it may not be possible to identify the specific assertions that are ~~more~~ susceptible to the risk (e.g., risk of management override of controls). In other cases, a number of assertions may be identified as susceptible to the risk, and which may therefore affect the auditor's risk identification and assessment of risks of material misstatement at the assertion level."

- Paragraph A216

We propose to delete it, as it is not useful guidance.

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 do not agree with the proposed stand-back requirement in paragraph 52 of ED-315 and the revisions made to paragraph 18 of ISA 330. We agree to establish stand-back requirements for both ISA 315 and ISA 330. However, it is difficult to understand the distinction between "significant" in ISA 315 and "material" in ISA 330 as described below. We believe it is difficult to implement them in practice and that they would cause unnecessary confusion.

- Paragraph 52 of ED-315

It is difficult to understand what kinds of classes of transactions, account balances or disclosures are considered to be material from the viewpoint of the financial reporting needs of users of financial statements, but not quantitatively or qualitatively significant from the viewpoint of the auditor's assessment of risks of material misstatement. Paragraph A241 describes a disclosure about executive compensation as an example of a class of transactions, account balances and disclosures that is not significant but is material in accordance with paragraph 52. While executive compensation is an item of high interest to shareholders and other stakeholders from the perspective of corporate governance, we believe it is not an appropriate example. In some jurisdictions, it is not required to be disclosed in the financial statements but is required to be disclosed in the corporate governance report. It is unclear what kinds of items are determined to be of high interest to users and therefore material, but not significant in terms of the auditor's risk assessments.

- Paragraph 18 of ISA 330

We cannot find an example of a class of transactions, account balances or disclosures that is not quantitatively or qualitatively significant (and therefore not covered by paragraph 52 of ED-315) but that is quantitatively or qualitatively material. We believe that the purpose of paragraph 18 of ISA 330 is to require substantive procedures for a class of transactions, account balances or disclosures that is quantitatively material, even if the assessed risk is low, in order to compensate for the limitations of the auditor's risk assessment. Therefore, we believe qualitative factors should not be included in paragraph 18 of ISA 330.

10) Do you support the proposed revision to paragraph 18 of ISA 330 to apply to class of transactions, account balances or disclosures that are "quantitatively or qualitatively material" to align with the scope of the proposed stand-back in ED-315?

Please see our comments on question 8) above.

Comments on Specific Paragraphs of ED-315

- Paragraph 39(c)

There is a difference in the scope of controls for paragraph 39(c) of ED-315 and paragraph 32(a) of ISA 240 (audit procedures responsive to risks related to management override of controls). Paragraph 32(a) of ISA 240 covers journal entries and other adjustments, while paragraph 39(c) of ED-315 does not cover adjustments in the process of preparing financial statements from the general ledger. If there is no particular intent to differentiate, the same phrase should be used.

- Paragraph A14

We propose deleting it. It is not particularly useful guidance and the first bullet (reference to ISA 240 and ISA 540) overlaps with paragraph A13.

- Paragraph A103

We propose the following modifications for readability.

> Notwithstanding the types of controls that are typically within each component of the entity's system of internal control, direct or indirect controls may exist in any of the components. In particular, the control activities component includes general IT controls, which may include 'indirect controls.' However ~~For example~~, controls that address the continued functioning of automated controls over the processing of transactions, such as controls over the integrity of information in the entity's information system, may also include 'direct controls."

- Paragraph A104

We propose deleting it. The second and third sentences overlap with paragraph A166, and the fourth sentence just repeats the requirement.

- Paragraph A113

Paragraph A113 describes that if a single individual has a strong influence on the entity, it may have an adverse effect or may have a positive effect. However, such a statement alone does not provide useful guidance. We propose to explain that, for example, consideration of the individual's competence and integrity is important in such a case.

- Paragraph A120

We believe that, in a smaller and less complex entity, it is rare that management routinely devote time to monitoring to identify risks associated with going-concern assumptions. We propose the following change to make the description more general (identification of emerging business risks).

> For example, in some smaller and less complex entities, and particularly owner-managed entities, an appropriate risk assessment may be performed through the direct involvement of management or the owner-manager (e.g., the manager or owner-manager may routinely devote time to monitoring the activities of competitors and other developments in the market place to identify emerging business risks ~~that may affect how the entity applies the requirements of the applicable financial reporting framework related to the entity's ability to continue as a going concern~~).

- Paragraph A140

We propose deleting the first sentence because it is a repetition of the requirement.

> ~~The auditor's understanding of the information system relevant to financial reporting required by paragraph 35 includes understanding the flows of information relating to the entity's~~

~~significant classes of transactions, account balances, and disclosures in the financial statements.~~ The auditor's understanding of the information system relevant to financial reporting is not required to include an understanding of the flows of information related to classes of transactions, account balances or disclosures that are not significant classes of transactions, account balances or disclosures.

- Paragraph A145

It should be referred from paragraph 41(a) (identification of risks arising from the use of IT), not from paragraph 35(d) (understanding of the entity's IT environment).

- Last sentence of paragraph A175

We propose the following change because it could be read as meaning that sufficient audit evidence can be obtained only from inquiries.

These techniques can be accompanied by inquires of management ~~or~~and inspection of supporting documentation.

- The penultimate and last sentences of paragraph A181

For clarity, we propose the following change.

Notwithstanding the types of controls that are typically within each component of the entity's system of internal control, direct or indirect controls may exist in any of the components. In particular, the control activities component includes general IT controls, which may include 'indirect controls.' However ~~For example~~, controls that address the continued functioning of automated controls over the processing of transactions, such as controls over the integrity of information in the entity's information system, may also include 'direct controls."

- The first sentence of paragraph A199

Operating effectiveness of controls can be maintained not only by automated controls but also by manual controls. Therefore, we propose the following change.

Evaluating the design and determining the implementation of controls relevant to the audit is not sufficient to test their operating effectiveness, unless there is some automat~~ion~~ed or manual controls that provides for the consistent operation of the controls.

- The last sentence of paragraph A213

We believe that the text needs reconsideration. Normally, the suspense account is not identified as a significant account balance.

- Last sentence of paragraph A225

We propose deleting it. It seems to indicate that if the design and performance of further audit procedures are appropriate, the assessment of inherent risks is appropriate. We believe the reverse (i.e., if the assessment of inherent risks is appropriate, the auditor can design and perform further audit procedures appropriately).

- Paragraph A227

Since the sentence is long and not easy to read, we propose reconsidering the text.