

# ISA 315 Risk Assessment

John Selwood

[2020innovation.com](http://2020innovation.com)



Opinion **Accountancy**

## The rising risk of ‘audit orphans’ in a dysfunctional UK market

Regulator Sir Jon Thompson flags the increasing chance that a large listed company is left without an auditor

HELEN THOMAS

+ Add to myFT



The regulator flagged another concern. As the Big Four come under pressure to improve quality, they are jettisoning companies seen as higher-risk from their portfolios. This “de-risking” means problematic or complicated clients can end up with smaller firms, whose experience and systems may not really be up to the job.

It is clear though that the Big Four, in safeguarding their reputations, have become more selective — a trend that is spreading to smaller firms, too.

Something has to



be done!

IAASB



# ISA 315 Practical impact



Risk  
assessment



Design of  
audit tests

# FRC Sanctions



'Multiple material misstatements'



Various critical failures



Inventory risk not followed up

## Highlights

ISA (UK) 315 (REVISED JULY 2020):  
Identifying and Assessing the Risks of  
Material Misstatement

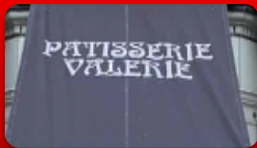
### ISA 315 Overview




### General IT controls



### Risk assessment



### Fraud risk



# ISA 315 UK (Revised) Identifying and Assessing the Risks of Material Misstatement

## Overview

# ISA 315 (Revised) Identifying and Assessing the Risks of Material Misstatement

## Revised ISA

- p/c 15  
December  
2021





## ISA 240 – Other changes


Also  
changing  
PC 15  
December  
2021

- Audit teams discussions
- Additional procedures?
- Use of forensic expertise
- Talk to whistle-blowers
- Unbiased testing

# ISA 315 - What has changed?

## High level summary

- Five new inherent risk factors (subjectivity, complexity, uncertainty, change and susceptibility to misstatement due to management bias or fraud).
- A new concept of 'spectrum of risk' which is the degree to which inherent risk varies.
- Requiring the auditor to obtain sufficient and appropriate audit evidence from risk assessment procedures.
- Significantly more requirements on IT, including general IT controls.
- Requiring inherent risk and control risk to be assessed separately.
- A new 'stand-back' provision



# ISA 315 UK (Revised) Identifying and Assessing the Risks of Material Misstatement

## Understanding internal controls - GITCs

## Understanding the components of the entity's system of internal control

### Internal controls

- Control environment
- The entity's risk assessment process
- The entity's process to monitor the system of internal control
- The information system and communication
- **Control activities**

# Understanding internal controls

## Control activities

- Significant risk
- Journal entries
- Reliance
- Others controls as appropriate

## IT controls

- Address material misstatement risk
- Identify relevant applications
- Identify IT-related risks
- Identify relevant IT general controls

# Understanding GITCs

Design and  
implementation

- Observation
- Inspection
- Enquiry

## Illustration 1

Many people nowadays work from home and from the office (known as 'hybrid' working). This will usually involve logging onto the firm's server to carry out their work.

The employee will enter various logon details, including passwords and there may also be a two-way authentication process whereby the user has to input a code that has been sent to another trusted device. Once the user's credentials have been correctly input, the system will allow access.

These are all IT controls to prevent unauthorised access to the IT system.

---

## Illustration 2

A client operates in the haulage business shipping goods from a central warehouse on behalf of its customer. Due to the nature of the business, the warehouse operates 24 hours a day, seven days a week. Warehouse staff are required to work shifts and must enter and exit the warehouse using a swipe card which has their details stored on it electronically. This swipe card records the number of hours worked, including overtime worked.

The electronic time recording system is also linked to the company's payroll system. Each week, the payroll department will import the hours worked from the electronic time recording system into the payroll system. A report is produced detailing the number of hours worked which is reviewed by the warehouse manager. The payroll cannot be finalised until the warehouse manager has signed off that week's hours worked report.

The payroll system automatically calculates the gross pay, statutory deductions and net pay. It also calculates the PAYE/NIC liability due to HM Revenue and Customs each month.



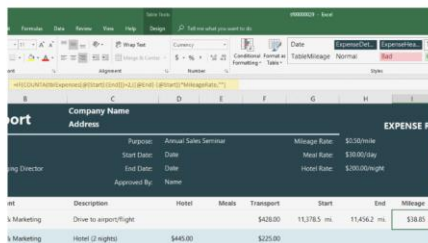
In this cycle, the auditor should review and document:

- The controls in place at the warehouse which aim to prevent employees being paid for hours not worked (the need to enter and exit the warehouse using the swipe card).
- The controls that are in place to ensure that the hours worked are accurately imported from the time recording system into the payroll system (the warehouse manager authorising the hours worked or a reconciliation carried out by the payroll department).
- Access controls over the payroll system itself.
- Controls over the payroll processing – ie, whether any reviews of information output from the payroll system is reviewed by a senior official prior to the payroll being finalised.
- Controls over the payment of the payroll to employees, ie, looking for segregation of duties between the payroll department and the physical payment of the payroll to employees.

# Spreadsheets

## In 2010, MI5 bugged the wrong phones due to a spreadsheet formatting error

A **formatting error** on MI5's list of phones to be tapped resulted in the agency's tapping 134 people entirely unrelated to investigations. The formatting error changed the last three digits of these phone numbers to 000 within the spreadsheet. As a result, random British citizens had their phones tapped by their government while the suspects went unobserved. Although it's not clear just what the unfortunate MI5 employee did to produce these results, it's pretty obvious what would happen if something similar affected your Excel expense-report template. For example, an employee might try to run a formula on the spreadsheet but use the wrong syntax, producing some potentially expensive results.



The screenshot shows an Excel spreadsheet with a formula bar at the top. The formula bar contains the text: `=IF(COUNTIF(B2:B10000,"000")>0, "Error: No phone numbers found", "Success: Phone numbers found")`. The spreadsheet has a table with columns: Company Name, Address, Purpose, Annual Sales Summary, Mileage Rate, \$10.00/mile, Start Date, Date, Meal Rate, \$18.00/day, End Date, Date, Hotel Rate, \$100.00/night, Approved By, Name. The table is titled "EXPENSE REPORT". Below the table, there is a summary table with columns: Description, Hotel, Meals, Transport, Start, End, Mileage. The summary table has two rows: "Marketing Drive to airport/flight" with values \$420.00, 113,785 mi, 11,456.2 mi, and \$18.00; and "Marketing Hotel (2 nights)" with values \$440.00, \$220.00, and empty cells for the other columns.

Company Name	Address	Purpose	Annual Sales Summary	Mileage Rate	\$10.00/mile	Start Date	Date	Meal Rate	\$18.00/day	End Date	Date	Hotel Rate	\$100.00/night	Approved By	Name
EXPENSE REPORT															
Description	Hotel	Meals	Transport	Start	End	Mileage									
Marketing Drive to airport/flight			\$420.00	113,785 mi	11,456.2 mi	\$18.00									
Marketing Hotel (2 nights)	\$440.00	\$220.00													

...as many as  
90% of  
spreadsheets  
contain  
mistakes.


### **Example – Sophisticated Enterprise Resource Planning (ERP) system**

Sunnie Enterprises Ltd has a bespoke ERP system in place which includes the accounting system. The financial controller prepares monthly management accounts and prepares the year-end trial balance. The finance director prepares the draft accounts ready for the auditors from the year-end trial balance.

The ERP system has been fully documented by the audit engagement team and tests of controls have been carried out during an interim audit which revealed the IT controls are working effectively.

A lot of the data from the ERP system is exported into manual spreadsheets which are used in the financial reporting process. As the financial controller prepares this documentation from a sophisticated accounting system, there are no further checks on this data.

In this situation, despite the business having a sophisticated accounting system with effective controls, these controls essentially become redundant once the data is worked on in a manual spreadsheet. Once work on the spreadsheets starts, no further checks are carried out.

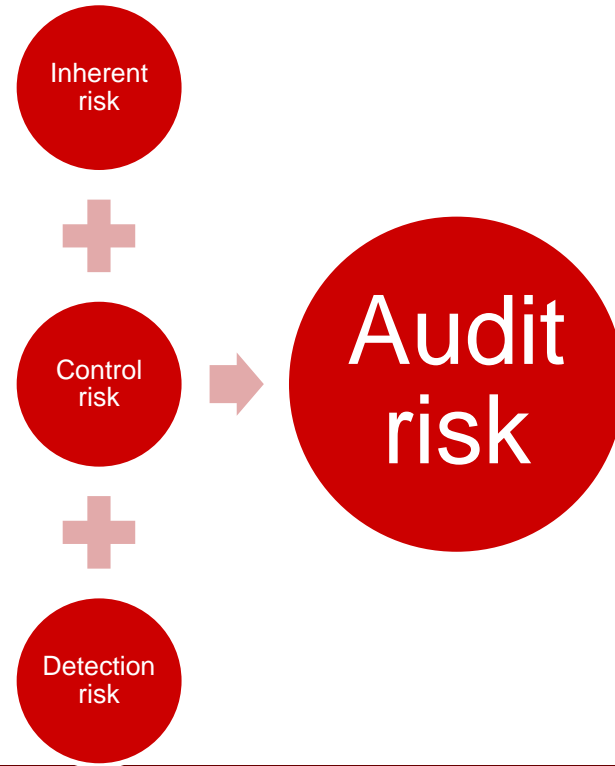


# ISA 315 UK (Revised) Identifying and Assessing the Risks of Material Misstatement

## Risk assessment

# ISA 315 (Revised) Identifying and Assessing the Risks of Material Misstatement

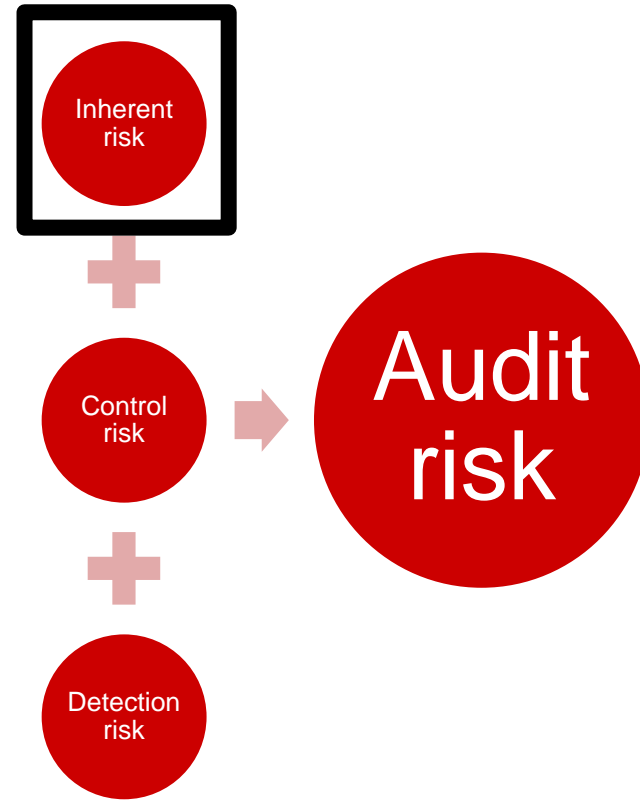
'spectrum of inherent risk'



# ISA 315 (Revised) Identifying and Assessing the Risks of Material Misstatement

## Inherent risk

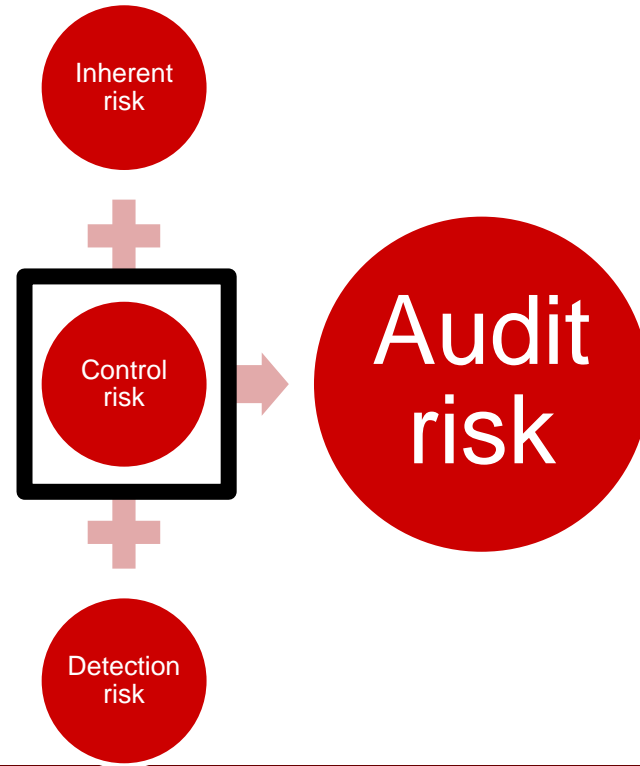
- (a) Inherent risk factors affect the susceptibility of relevant assertions to misstatement; and*
- (b) The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level.*



# ISA 315 (Revised) Identifying and Assessing the Risks of Material Misstatement

## Control risk

34. If the auditor plans to test the operating effectiveness of controls, the auditor shall assess control risk. If the auditor does not plan to test the operating effectiveness of controls, the auditor's assessment of control risk shall be such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.



# Inherent risk factors

Subjectivity

Complexity

Uncertainty

Change

Susceptibility to  
misstatement due  
to management  
bias or fraud



# Inherent risk factors - examples

## Complexity

- Business model: The existence of complex alliances and joint ventures

## Subjectivity

- Financial reporting framework: A wide range of possible measurement criteria of an accounting estimate

## Change

- IT: Installation of significant new IT systems related to financial reporting

## Uncertainty

- Reporting: Pending litigation and contingent liabilities,

## Susceptibility to misstatement due to management bias or fraud

- Transactions: that are recorded based on management's intent, for example, restructuring

## Example – in the audit of Entity C

### Assertion level risk

C has prepared its draft financial statements for the year ended 31 March 20X2. During discussions with the head of finance it became apparent that due to current economic conditions a significant part of the debtor book is unlikely to be recovered.

The relevant assertion in this instance is 'valuation'. The significant account balance is debtors. This is because if the debtor balance is not written off, receivables and profit could both be materially overstated.

Also keep in mind that the determination of a relevant assertion is made **before** the auditor considers any related controls the client has in place which could minimise the risk (i.e. 'inherent risk').

Complexity

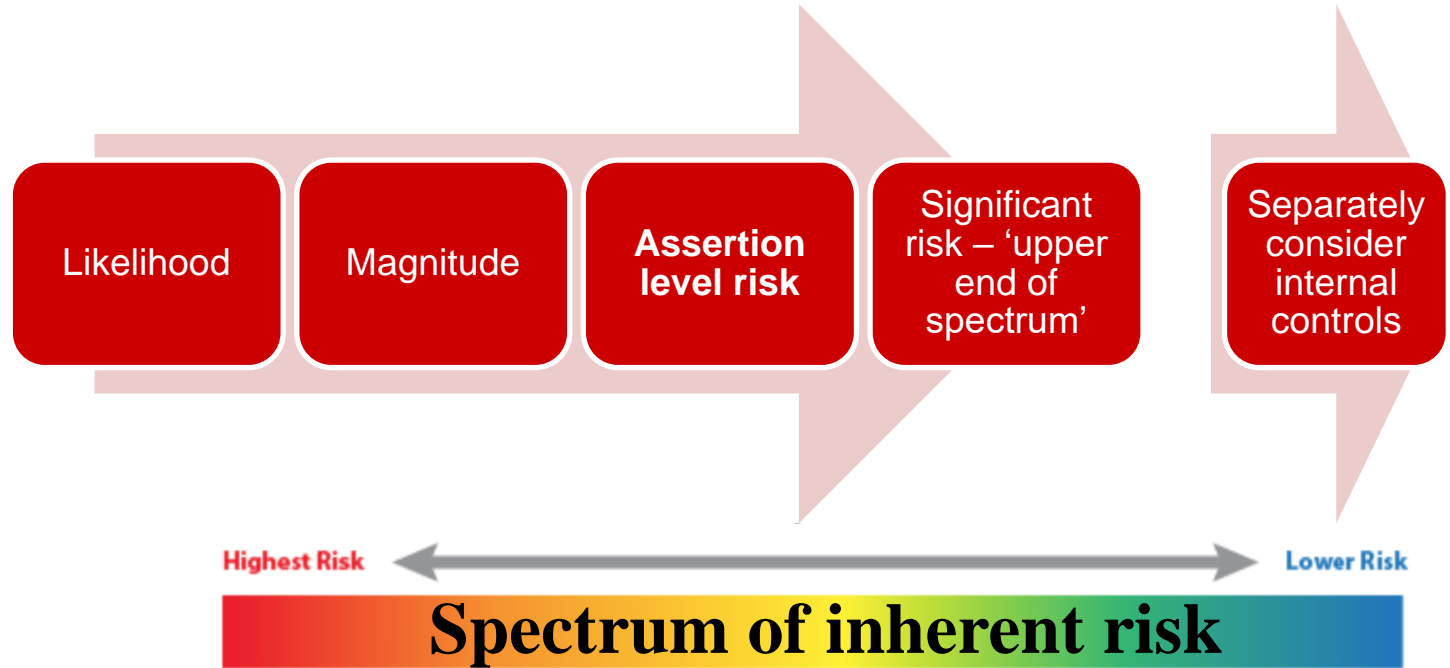
Subjectivity

Change

Uncertainty

Bias or fraud

# Spectrum of inherent risk



## Example – in the audit of Entity D

### Assertion level risk

D Developers Ltd, are redeveloping an office block into residential apartments. The project is 75% complete at the year end and all units have been sold off plan and are budgeted to make a profit. This is one of a number of ongoing similar projects that the company is undertaking. Assess inherent audit risk using the five inherent risk factors.

Complexity

Subjectivity

Change

Uncertainty

Bias or fraud

## Example – in the audit of Entity F

### Assertion level risk

F Brands Ltd, supplies goods to major retailers. Most shipments are sent direct from suppliers to the customers.

F Brands Ltd operates a significant rebate scheme rewarding customers who purchase large volumes.

Determine the inherent risks in revenue.

Complexity

Subjectivity

Change

Uncertainty

Bias or fraud

## Example

Assertion  
level risk

Fixed assets?

Complexity

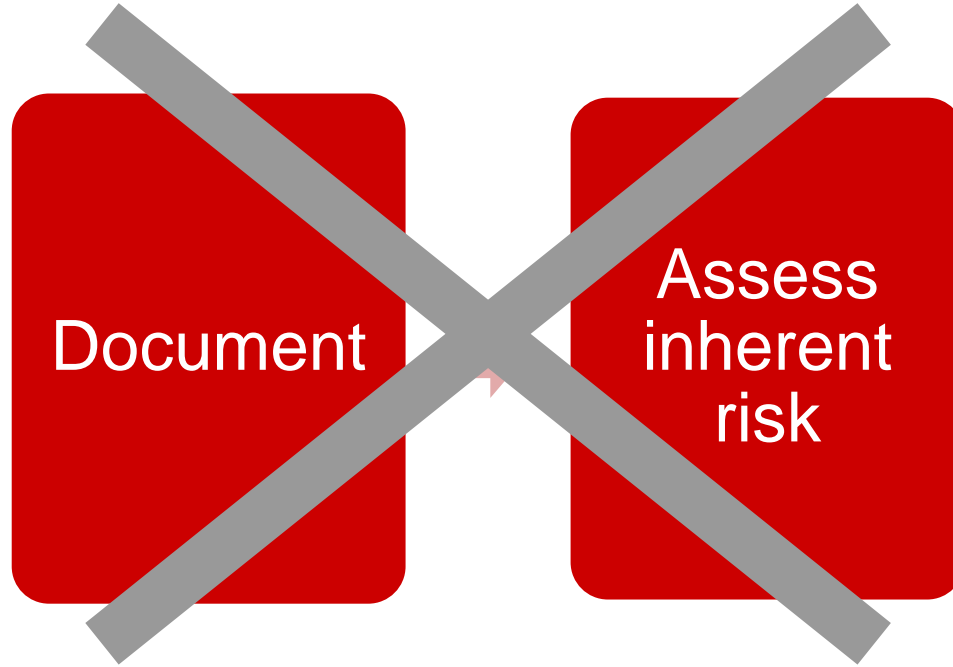
Subjectivity

Change

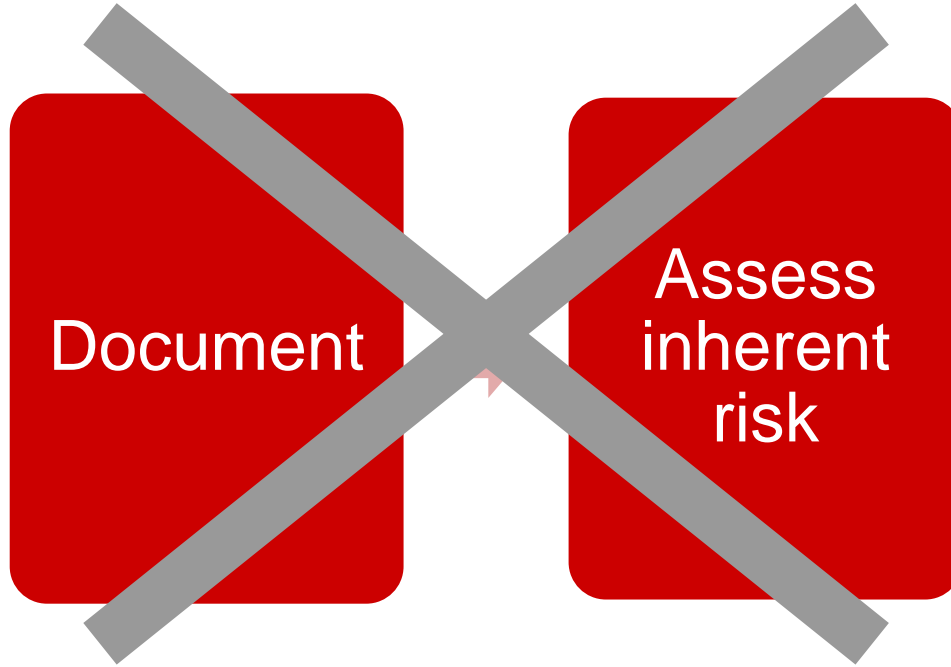
Uncertainty

Bias or fraud

# The documentation problem



# The documentation problem





# The documentation problem

Assertion  
level


Granularity

Scalability

Assess  
inherent  
risk



Document



# ISA 315 UK (Revised) Identifying and Assessing the Risks of Material Misstatement

Don't forget

# ISA 315 (Revised) Stand back



## *Evaluating the Audit Evidence Obtained from the Risk Assessment Procedures*

35. The auditor shall 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. If not, the auditor shall perform additional risk assessment procedures until audit evidence has been obtained to provide such a basis. In identifying and assessing the risks of material misstatement, the auditor shall take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management.

# ISA 315 (Revised) Iterative nature of risk assessment

## *Revision of risk assessment*

If the auditor obtains new information which is inconsistent with the audit evidence on which the auditor originally based the identification or assessments of the risks of material misstatement, the auditor shall revise the identification or assessment



A large red circular graphic on the left side of the slide, consisting of two concentric circles. The outer circle is larger and the inner circle is smaller, both centered vertically. The right side of the circles is cut off by the edge of the slide.

# Fraud risk

# Detecting fraud – ISA 240 (Revised)



## Para 7-1

While, as described above, the risk of not detecting a material misstatement resulting from fraud may be higher than the risk of not detecting one resulting from error, that does not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud. Reasonable assurance is a high, but not absolute, level of assurance.

# Spectrum of inherent risk - example

## ISA example

- *Cash at a supermarket retailer would ordinarily be determined to be a high likelihood of possible misstatement (due to the risk of cash being misappropriated), however, the magnitude would typically be very low (due to the low levels of physical cash handled in the stores). The combination of these two factors on the spectrum of inherent risk would be unlikely to result in the existence of cash being determined to be a significant risk*







The content of this course, along with the slides and accompanying notes, remains the copyright of the presenter and should not be reproduced, shared or distributed without permission.

Where this document contains public sector information, this is licensed under the Open Government Licence v3.0 ([www.nationalarchives.gov.uk/doc/open-government-licence/version/3/](http://www.nationalarchives.gov.uk/doc/open-government-licence/version/3/)).

Where reference is made to professional body websites, the copyright for the material in question is retained by the relevant professional body. UK Accounting, Auditing and Ethical Standards are © Financial Reporting Council Ltd (FRC) (<https://www.frc.org.uk/about-the-frc/procedures-and-policies/disclaimer-and-copyright>).

20:20 Innovation cannot accept responsibility for any person acting or refraining to act as a result of any material contained in this document or information otherwise shared during or after the training course to which it relates.

