



November 24, 2020

Ms. Sherry Hazel
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: ASB Proposed SAS, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Dear Ms. Hazel:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to speak on behalf of local and regional firms and represent those firms' interests on professional issues in keeping with the public interest, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective.

TIC appreciates the effort of the Auditing Standards Board (ASB) to enhance the auditing standards related to the auditor's risk assessment. TIC also appreciates the opportunity to have had a TIC member participate in the Task Force and provide input as this revised standard was being developed.

Effective risk assessment is important in the effort to enhance audit quality. TIC agrees that many firms struggle with risk assessment and how to scale the standards to less complex entities. TIC believes this exposure draft (ED) attempts to address many of the scalability issues in the application paragraphs.

To achieve the objective of enhancing audit quality, it is important the standard is easy to understand so it can be appropriately and consistently utilized in practice. While TIC believes this standard is well designed, TIC members had varying interpretations of some very key aspects of the risk assessment process. Areas where TIC believes clarifications are needed are addressed in our responses to questions 2, 4 and 5.

TIC understands that effectively addressing all aspects of risk assessment while providing appropriate scalability results in a lengthy standard and application guidance. However, the length and complexity also make it more difficult to understand. TIC believes that adding a summary to the application guidance that helps auditors understand the flow of the risk assessment process to enhance understandability would be helpful. Many of the smaller firms that TIC represents do not have the resources to dedicate to fully evaluating all aspects of this standard and a summary would enhance their understanding and ensure consistent application

of appropriate risk assessment procedures. Additional resources in an audit guide and nonauthoritative practice aid would also be beneficial. TIC would be happy to assist in the development of any additional guidance.

Question 1: *Are the requirements and application material of the proposed SAS sufficiently scalable, that is, is the proposed SAS capable of being applied to the audits of entities with a wide range of sizes, complexities and circumstances?*

TIC knows that significant work has been done to make the proposed SAS scalable and we believe the SAS can be applied to a range of audits of various sizes, complexities, and circumstances.

TIC believes that the primary opportunity for scalability exists in the understanding of internal controls for audits of less complex entities. Subject to our suggestions for clarification in our response to Question 2, TIC believes that the requirements of the ED regarding understanding internal controls is appropriate for audits of entities of all size and complexity.

Question 2: *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?*

TIC believes the requirements to understand each component of the entity's system of internal control generally have been appropriately enhanced and clarified in this ED. Paragraphs 21 through 25 regarding the internal control components, control environment, risk assessment, monitoring and communication are helpful. TIC especially appreciates that the determination of whether a control has been implemented is only specifically required for controls specified in paragraphs 26a and c(ii) and believes this greatly enhances scalability.

However, TIC does not think that the distinction between an understanding through performing risk assessment procedures as used in paragraphs 21 through 25 and the requirements of paragraph 26d pertaining to control activities is sufficiently clear. In particular, the description of risk assessment procedures in paragraph 14 and the application guidance in A36 to A38 could be interpreted to mean a similar level of effort would be required for these other internal control components as intended for control activities in paragraph 26d.

In order to enhance the clarity of the requirements in paragraphs 21 to 25, TIC suggests one or more of the following:

- Add clarifying language to paragraphs 21 through 25 to specify that obtaining an understanding of the controls discussed in those paragraphs is different from the procedures in paragraph 26d. Perhaps the standard could include an explicit statement that testing the implementation of specific controls is not required to satisfy paragraphs 21-25.
 - Clarify paragraph 14, by distinguishing between risk assessment procedures to understand controls and other risk assessment procedures and/or to indicate that risk assessment procedures should include **one or more of** the following instead of “should include the following.”
 - Enhance the application guidance to make clear the intent of *risk assessment procedures* relative to understanding each of the components of internal control.
 - Clarify that, for indirect controls, inquiry alone may be sufficient.
- b. *Have the requirements related to the auditor’s identification of controls that address the risks of material misstatement been appropriately enhanced and clarified? Is it clear how controls that addressed the risks of material misstatement are identified, particularly for audits of smaller and less complex entities?*

TIC believes that the requirement to identify the controls that address *significant risks* are clear; however, it is unclear whether there is a requirement to identify controls that are relevant to significant classes of transactions, account balances, or disclosures. Paragraph 26a does not specifically identify controls that address significant classes of transactions, account balances, or disclosures in 26a i through iv. TIC understands that the omission of significant classes in paragraph 26a was intentional. However, TIC believes it is possible to interpret paragraph 26a to indicate control activities that address RMM for *all* significant classes of transactions, account balances, and disclosures must be evaluated for design and implementation.

TIC believes that clarity would be enhanced by restating paragraph 26a to “identifying control activities that address risks of material misstatement at the assertion level for the following:” versus the current language which indicates, “identifying control activities that address risks of material misstatement at the assertion level as follows:”

TIC recommends that the related application guidance also should be enhanced to make it clear that it is not intended that control activities related to **all** significant classes of transactions, account balances, or disclosures be identified and evaluated for design and implementation.

- c. *Given that COSO's 2013 Internal Control—Integrated Framework (COSO framework) is often used by entities subject to the AICPA’s generally accepted auditing standards, is the terminology in paragraphs 21–27 and related application material of the proposed SAS clear and capable of consistent interpretation for audits of entities that use the COSO framework?*

TIC believes that the terminology in the standard and application material is clear and capable of consistent application.

Question 3: *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 clear 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?*

TIC believes documentation of the considerations of the role of IT and related risks may prove challenging. However, TIC appreciates that the increased emphasis on assessing and documenting IT controls is appropriate and necessary. The table of factors to consider should assist auditors of smaller firms. While we believe this may prove challenging for some firms, the requirement to obtain an understanding of the IT environment, risks from IT, and the identification of IT controls is clear and appropriate.

TIC believes that many of the firms we represent will need additional training and tools on the use of IT in audits and risk assessment to effectively implement these enhanced requirements. Assistance in the form of tools such as checklists, like the AICPA checklist for the use of SOC reports, and other training and guidance provided by the ASB in coordination with others will be important.

Question 4: *Do you support the introduction in the proposed SAS 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 (that is, that 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?*

TIC supports the new concepts and definitions, but we believe the definitions of relevant assertions and significant class of transactions, account balances, or disclosure should be enhanced.

TIC recognizes that the identification of significant classes of transactions, account balances, or disclosures is critical as it represents risk areas that require specific action in proposed AU-C 330.07 and .18. Therefore, it is important that the definitions allow for the appropriate identification of significant classes, account balances, or disclosures.

TIC believes that additional guidance is needed to assist auditors in identifying which classes of transactions, account balances or disclosures are deemed to be significant classes. Discussions among TIC members about the ED indicated there are significantly varying views of how to interpret the definitions of relevant assertions and, therefore, significant classes of transactions, account balances, or disclosures.

To illustrate the importance of the requested clarification, the definition of significant classes of transactions, account balances, or disclosures (significant class) in paragraph 12 is dependent on the definition of relevant assertions. The definition of relevant assertions in paragraph 12 indicates that an assertion is relevant when it has an identified risk of material misstatement. That can be interpreted as being anywhere on the spectrum of inherent risk, from a relatively low RMM to a very high RMM. This could result in every assertion for every class of transactions, account balances, or disclosures to be considered a relevant assertion and significant class. Therefore, it is critical to understand if identified RMM at any level causes an assertion to be a relevant assertion.

TIC believes that every assertion for every class of transactions, account balances or disclosures should not necessarily be a relevant assertion resulting in significant classes, and in the following paragraphs we attempt to identify where clarification could be added.

Paragraph A11 attempts to add clarification by indicating that a risk of material misstatement exists when there is a reasonable possibility of a misstatement occurring and there is a reasonable possibility of the misstatement being material. Breaking down the consideration into odds of occurrence and whether a potential misstatement could be material is very helpful. However, “reasonable possibility” is not defined. Focusing on the odds of occurrence, TIC was curious as to where on the spectrum “reasonable possibility” would be. TIC believes reasonable possibility would be better understood by providing a definition or perhaps some additional guidance and considerations within paragraph A11.

The ED introduces the concept of a spectrum of inherent risk. The term “significant risk” as defined in paragraph 12 is defined relative to the spectrum as a risk that is close to the upper end of the spectrum. However, “significant class” and “relevant assertion” are not defined relative to the spectrum of inherent risk. Also, paragraph A11 does not relate “reasonable possibility” to the spectrum. It would be helpful if clarity were added to paragraphs 12 and A11.

TIC would prefer to see the clarification by reference to the spectrum of inherent risk. TIC appreciates that it may be too prescriptive to specify where exactly on the spectrum reasonable possibility or relevant assertion might occur. However, clearly indicating that a low inherent risk and low RMM might not result in a relevant assertion even though the inherent risk is on the spectrum would be an important enhancement to the definition. It also would help if this requested clarification was part of the definition and not just application guidance.

As previously mentioned, the definitions as presented in the ED could be interpreted in a way that every assertion for every class of transaction or account balances could be a significant class. TIC does not believe that is the intent and does not believe that should be the case, which is why clarification is critical.

Question 5: *Do you support the introduction of the spectrum of inherent risk into the proposed SAS?*

TIC supports the introduction of the spectrum of inherent risk and many firms already have audit methodologies that incorporate this concept; however, some members had varying points of view about the how the spectrum would work in practice.

One point of view is that the spectrum of inherent risk goes from no risk on the lowest end to extremely high risk on the upper end. That means that assertions for which inherent risk is deemed to be low might not be considered relevant assertions. The other point of view is that the spectrum starts on the lower end at a level of inherent risk which would result in a RMM giving rise to a relevant assertion, and therefore inherent risk that would not result in a relevant assertion is not even on the spectrum.

TIC recognizes that the latitude to develop methodologies and designate risks of material misstatement within categories might mean that a methodology could adopt either interpretation and still comply with the requirements of the risk assessment standards. However, since TIC is requesting clarification of reasonable possibility and relevant assertion by reference to the spectrum of inherent risk in our response to Question 4, this issue could be an important clarification and result in less diversity in practice.

Question 6: *Do you support the separate assessments of inherent and control risk in relation to all risks of material misstatement at the assertion level?*

TIC supports the separate assessments of inherent and control risk. We believe this method aligns with the methodology many auditors already have been applying.

Question 7: *What are your views regarding the clarity of the requirement to assess the control risk, in particular, when the auditor does not plan to test the operating effectiveness of controls?*

TIC believes the requirement to obtain an understanding of the design and implementation of controls in paragraph 26d is clear. However, please see our comments regarding paragraphs 21 through 25 in response to question 2a above. We also believe the language in paragraph 34 clarifies that risk of material misstatement is the same as inherent risk when the auditor does not plan to test the operating effectiveness of controls.

Question 8: *What are your views regarding the clarity of the requirement in paragraph 26d of the proposed SAS to evaluate design and determine implementation of certain control activities (including, specifically, the requirement related to controls over journal entries)?*

TIC is supportive of the requirement to determine the design and implementation of certain controls, including those over journal entries. As previously mentioned, clarity in paragraph 26a regarding significant classes of transactions, account balances, or disclosures is important to understand when paragraph 26d applies.

Question 9: *Do you support the revised definition, and related material, on the determination of significant risks? What are your views on the matters previously presented relating to how significant risks are determined based on the spectrum of inherent risk?*

TIC supports the definition of significant risks and how significant risks are determined based on the spectrum of inherent risk.

Question 10: *What are your views about the proposed stand-back requirement in paragraph 36 of the proposed SAS and the conforming amendments proposed to paragraph .18 of AU-C section 330?*

TIC is supportive of the stand-back concept and TIC believes the amendment to AU-C 330.18 is clear in that it requires substantive procedures for relevant assertions for significant classes of transactions, account balances, and disclosures.

Question 11: *What are your views with respect to the clarity and appropriateness of the documentation requirements?*

TIC appreciates that the documentation requirements allow for scalability; however, we realize that can also make determining specifically what is required to be documented challenging. Paragraph A259 states, “for recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity’s business or processes.” This may lead to confusion as practitioners may interpret this to imply that walkthroughs, as an example, aren’t required each year to indicate a control has been implemented. TIC suggests either removing this sentence or specifying what may be carried forward for documentation purposes.

TIC was concerned what, if any, additional documentation would be required related to paragraphs 36 and 37, particularly since the performance of the stand-back requirements could result in no change to the risk assessments.

The language in paragraphs A262 and A263 of the ED helps by identifying that every inherent risk factor considered is not required to be documented which should help ease some confusion seen in the application of the extant standard.

TIC has seen certain risk assessment documentation expectations included in peer review checklists, even when specific documentation requirements are not explicitly stated in the standards. TIC would urge the ASB to make any documentation requirements as clear as possible and potentially work with the Peer Review team to ensure there are no unintended consequences for firms during peer reviews.

ADDITIONAL COMMENTS

Classes of Transactions

Even though the term “classes of transactions” is widely used in professional standards, TIC noted that this standard does not provide guidance for grouping classes of transactions or account balances. We fully appreciate that classes of transactions or account balances will vary based on the unique nature of each audited entity. However, we believe that, for risk assessment to be effective, the appropriate grouping of transaction classes or account balances is very important. Inappropriate aggregation (or disaggregation) of transaction classes or account balances so the risk characteristics for each assertion are varying and/or inconsistent might lead to inappropriate risk assessment and inappropriate substantive audit responses. TIC believes application guidance which at least identifies important criteria to consider in identifying classes of transactions or account balances should be provided.

Governmental Entities

TIC members also noted that the application guidance includes various paragraphs headed “Considerations Specific to Governmental Entities” and observed that those paragraphs could also provide guidance to other regulated entities. TIC believes ASB should consider whether that heading should be broader as this guidance could be applied to entities beyond just governmental. Or, if this guidance was only intended to apply to governmental entities, that should be clarified.

Understandability

As previously mentioned, TIC has concerns related to the ability of smaller firms to understand and appropriately apply the standard. With the length and complexity of this SAS, TIC believes auditors in smaller firms may have difficulty applying the standard to audits of less complex entities they may frequently encounter.

TIC believes it would help smaller firms apply the SAS if the application material included an Appendix with a visual aid, or outline, of the unconditional and presumptively mandatory requirements and documentation needed to adhere to the SAS. While we acknowledge this could result in auditors simply looking to that practice aid rather than understanding the entirety of the standard, TIC believes it could be written in a manner to mitigate this risk. TIC would be happy to assist in development of any practice aids or implementation guidance related to enhancing the understandability of the standards for less complex entities.

TIC also understands that while the scalability in the standard provides for the principles of sound risk assessment to be appropriately applied to audits of all sizes and complexities, it also might provide the latitude to scale back risk assessment procedures and documentation to the point where audit quality is compromised. Therefore, we question whether the implementation

guidance should specify that an audit will generally have some level of risk that should be documented. This clarification would be very helpful for auditors of less complex entities.

TIC appreciates the opportunity to present these comments on behalf of PCPS Member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "Danielle Supkis-Cheek", with a long, sweeping flourish extending to the right.

Danielle Supkis-Cheek, Chair
On Behalf of the PCPS Technical Issues Committee