Agenda Item 1

AU-C 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*

Objective of Agenda Item

To discuss selected issues related to the proposed SAS, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, and to obtain the ASB's direction on these issues.

Task Force

The Task Force members are as follows:

- Maria Manasses–GT, Chair (succeeded Tracy Harding)
- Diane Hardesty–EY
- Kathy Healy–PwC
- Susan Jones–KPMG
- April King–RSM
- Tania Sergott–Deloitte
- Dan Wernke–Clark Schaefer Hackett

In leading the ASB discussion, Ms. Manasses will refer to this Issues Paper.

Background

On August 27, 2020, the Auditing Standards Board (ASB) issued the Exposure Draft ("ED") related to the proposed SAS. The Exposure Draft period ended November 25, 2020. Thirty-two comment letters were submitted by responders. The comment letters expressed support of the overall objectives of the ED and the general direction of the project. However, the comment letters suggested further refinements to the proposed SAS and drafting recommendations that will need to be further evaluated by the Task Force.

At the January 2021, the ASB discussed the feedback received in the comment letters and discussed the following:

I. Matters that Require ASB's Strategic Direction
II. Matters Raised by Responders that Contain the Task Force's Preliminary Views
III. Matters Raised by Responders to be Addressed by the Task Force after the ASB Meeting

The Risk Assessment Task Force met on February 3 and 23, 2021 to continue evaluating the comment letters received. The issues presented below represent the issues that the Task Force would like feedback and direction from the ASB in order for the Task Force to develop specific changes to the proposed SAS to be presented at the May 2021 ASB meeting.

I. Understanding Processes and Controls Related to Journal Entries

Issue	To what extent is the auditor required to understand controls over journal entries?
Discussion	Several responders commented on the requirement in paragraph .26(a)(ii) to understand controls over journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments. Among other things, comments specifically related to the following: • The proposed requirement is broader than the extant requirement, based on how it has been positioned in the proposed SAS • The requirement infers that the auditor is required to understand all journal entries, which they did not believe was the IAASB's intent • Clarification of the proposed requirement in the context of the extant requirement in AU-C section 240 related to controls over journal entries and other adjustments related to the financial reporting process is necessary. For purposes of analyzing the issue, the following table provides relevant requirements from extant standards.

Extant AU-C section 315	.19 The information system, including the related business processes relevant to financial reporting and communication. The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas: a. The classes of transactions in the entity's operations that are significant to the financial statements. b. The procedures within both IT and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements. c. The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions. This includes the correction of incorrect information and how information is

		transferred to the general ledger. The records may be in either manual or electronic form. d. How the information system captures events and conditions, other than transactions, that are significant to the financial statements. e. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures. *f. Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.*
	Extant AU-C section 240	.32 Even if specific risks of material misstatement due to fraud are not identified by the auditor, a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to a. test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts. In designing and performing audit procedures for such tests, the auditor should (Ref: par. .A47–.A50 and .A56) i. obtain an understanding of the entity's financial reporting process *and controls over journal entries and other adjustments, and the suitability of design and implementation of such controls*; ii. make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments; iii. consider fraud risk indicators, the nature and complexity of accounts, and unusual entries processed; iv. select journal entries and other adjustments made at the end of a reporting period; and

	v. consider the need to test journal entries and other adjustments throughout the period.
Extant AU-C section 330	.21 The auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as a. agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers, and b. *examining material journal entries and other adjustments made during the course of preparing the financial statements*. (Ref: par. .A57)
Extant AU-C section 550	.15 The auditor should inquire of management and others within the entity and perform other risk assessment procedures considered appropriate to *obtain an understanding of the controls*, if any, that management has established to (Ref: par. .A16–.A21) a. identify, account for, and disclose related party relationships and transactions. b. authorize and approve significant transactions and arrangements with related parties. (Ref: par. .A22) c. authorize and approve significant unusual transactions, and arrangements outside the normal course of business.

As a reminder, the Board discussed this matter prior to exposure of the proposed SAS and included additional application material to clarify that the requirement in paragraph 26(a)(ii) does not apply to all journal entries. As a result of these discussions, the Board also requested comments in the ED regarding the clarity of this requirement. The following guidance was included in the proposed SAS.

> A176. Controls that address risks of material misstatement at the assertion level that are expected to be identified for all audits are controls over journal entries because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or nonstandard, or automated or manual. *Paragraph 25a requires the auditor to obtain an understanding of the flows of information in the entity's information system for significant classes of*

	transactions, account balances, and disclosures. The understanding required by paragraph 26a(ii) includes controls over adjustments to significant classes of transactions, account balances, and disclosures that may not be subject to controls over processing of routine transactions. Further, the auditor may have identified no related party transactions that meet the definition of significant unusual transactions in accordance with AU-C section 240, other significant risks, or other risks of material misstatement for which it is necessary for the auditor to evaluate the design of controls and determine that they have been implemented. In such an audit, the auditor may determine that there are no identified controls other than the entity's controls over journal entries. ISA 315 (Revised 2019) provides the following guidance: A160. Controls that address risks of material misstatement at the assertion level that are expected to be identified for all audits are controls over journal entries, because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. *The extent to which other controls are identified may vary based on the nature of the entity and the auditor's planned approach to further audit procedures.*
Preliminary views	The majority of the Task Force believes revisions to paragraphs .25 and .26 of the proposed SAS are necessary, considering the comments received as well as other requirements in GAAS. The Task Force notes the following: • AU-C section 240 addresses controls over journal entries and other adjustments related to the financial reporting process, similar to extant AU-C section 315 (as AU-C 240 refers to AU-C 315 in a footnote) • AU-C section 550 addresses various controls over the identification, accounting, authorization, and approval of related party relationships and significant unusual transactions • Proposed paragraph .25 includes understanding, for significant classes of transactions, account balances, and disclosures, how information is recorded, corrected as necessary, and incorporated in the general ledger • Controls over journal entries (which the auditor is required to obtain an understanding of) may be identified in accordance with proposed paragraph .26(a)(i) relating to significant risk, .26(a)(iii) relating to testing operating effectiveness, or 26(a)(iv) relating to other controls that the auditor considers appropriate.

	Accordingly, the Task Force believes revisions to the proposed SAS can be focused on clarifying the auditor's responsibilities related to significant nonrecurring, unusual transactions.
Proposed changes	***The Information System and Communication*** 25. The auditor should, through performing risk assessment procedures, obtain an understanding of the entity's information system and communication relevant to the preparation of the financial statements by (Ref: par. A144–A145) a. understanding the entity's information-processing activities, including its data and information, the resources to be used in such activities and the policies that define, for significant classes of transactions, account balances, and disclosures (Ref: par. A146– A158) i. how information flows through the entity's information system, including how (a) transactions***, including nonrecurring, unusual transactions,*** are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger, and reported in the financial statements and (b) information about events and conditions, other than transactions, is captured, processed, and disclosed in the financial statements, ii. the accounting records, specific accounts in the financial statements, and other supporting records relating to the flows of information in the information system, iii. the financial reporting process used to prepare the entity's financial statements, including disclosures, and iv. the entity's resources, including the IT environment, relevant to preceding a(i) to a(iii). ***Control Activities*** 26. The auditor should, through performing risk assessment procedures, obtain an understanding of the control activities component by (Ref: par. A162–A173) a. identifying controls that address risks of material misstatement at the assertion level in the control activities component as follows: i. Controls that address a risk that is determined to be a significant risk (Ref: par. A174–A175) ii. Controls over ~~journal entries, including~~ nonstandard journal entries used to record ***significant*** nonrecurring, unusual transactions~~,~~ or adjustments***. AU-C section 240 requires the auditor to obtain an understanding of the entity's financial reporting process and***

	controls over journal entries and other adjustments in order to design and perform audit procedures to test the appropriateness of such journal entries and other adjustments to address the risk of management override of controls. (Ref: par. A176–A177)
Questions for the Board	Does the Board agree with clarifying the auditor's responsibilities relating to understanding controls over journal entries? If so, does the Board agree with: • The proposed changes to paragraph .25 of the proposed SAS (which provides additional context for and also aligns with the requirement related to controls in paragraph .26) or, alternatively, does the Board prefer addressing nonrecurring, unusual transactions within the application material? • The proposed changes to paragraph .26 of the proposed SAS to clarify which journal entries are the focus of the auditor's efforts to evaluate design and implementation of identified controls in AU-C 315 (that is, nonstandard journal entries used to record significant nonrecurring, unusual transactions or adjustments), or alternatively, does the Board prefer other modifications (for example, modifying the requirement in AU-C 240 and clarifying the proposed requirement in AU-C 315 within the application material)?

II. Definition of a Relevant Assertion

Issue	Should the definition of a "relevant assertion" revert to the definition in extant AU-C section 315, which also aligns with PCAOB standards?
Discussion	Comments received indicated that the proposed SAS is unclear about the definition of a relevant assertion and whether inherent risk is part of determining that there is an identified risk of material misstatement and, therefore, a relevant assertion. A comment was also made that reasonable possibility is not related to the spectrum of inherent risk (neither is significant class or relevant assertion). Outreach sessions suggested that certain definitions, including the definition of a relevant assertion, are difficult to comprehend because they are difficult to navigate (that is, certain definitions build upon each other and multiple paragraphs need to be considered to understand them). The following table summarizes the definitions in extant AU-C section 315, PCAOB standards, and the proposed SAS.

Extant AU-C section 315	PCAOB standards	Proposed SAS (Aligns with text in ISA 315)
A financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of internal controls.	A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.	An assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement. The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (that is, the inherent risk).
Note: The definition in the proposed SAS aligns with ISA 315 (Revised 2019). Unlike extant AU-C section 315, extant ISA 315 (Revised) does not include a definition of a relevant assertion.		

The proposed SAS includes the following application material, which addresses the "identified risk of material misstatement" in the definition of a relevant assertion in the proposed SAS:

> A11. A risk of material misstatement may relate to more than one assertion, in which case, all the assertions to which such a risk relates are relevant assertions. For the purposes of the AU-C sections, a risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). If an assertion does not have an identified risk of material misstatement, then it is not a relevant assertion.

Preliminary views

The Task Force recognizes the overall objective to converge with the ISAs, while also considering PCAOB standards to avoid the creation of unnecessary differences. The Task Force also recognizes the importance of the interplay between the definitions, the requirements, and the application material and, therefore, the need to be cautious if proposing changes so as not to cause inconsistencies within the proposed SAS. At the same time, the Task Force

	recognizes comments received, the importance of clear definitions that may eliminate the need to navigate a lengthy standard, and the fact that GAAS had already included a definition (unlike the ISAs). Accordingly, the Task Force is requesting the ASB's strategic direction on this matter; potential options for consideration follow. The Task Force had varying views with regard to the options presented, each of which (for Options 1 – 4) was supported by at least one Task Force member. The majority of the Task Force, however, preferred Option 1, which retains the definition in ISA 315 (Revised 2019) but supplements the definition with language that had been included in the application material. It is important to note that the Task Force believes that, regardless of the option selected, the concept of a relevant assertion is intended to be the same across the ISAs, GAAS, and PCAOB standards.
Potential options	**Option 1** – Include the application material in paragraph A11. within the proposed definition **Relevant assertions.** An assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement. ***A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).*** The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (that is, the inherent risk). **Option 2** – Include a modified version of the application material in paragraph A11. within the proposed definition and keep paragraph A11. intact. **Relevant assertions.** An assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement ***(that is, there is a reasonable possibility of a misstatement occurring and, if it were to occur, a reasonable possibility of the misstatement being material)***. The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (that is, the inherent risk). **Option 3 –** Include a modified version of the extant definition, which also aligns closer with PCAOB standards. **Relevant assertions.** A***n*** ~~financial statement~~ assertion ***about a class of transactions, account balance, or disclosure*** that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made ~~without regard to the effect of internal~~

	before consideration of any related controls ***(that is, the determination is based on inherent risk)***. **Option 4** – No change to the definition included in the Proposed SAS **Option 5** – Keep the definition in extant AU-C section 315 without any changes
Questions for the Board	What are the Board's views and which option is preferred?

III. Definition of a Significant Class of Transactions, Account Balance, or Disclosure

Issue	Should the definition of a "significant class of transactions, account balance, or disclosure" be enhanced to clarify its connection to an identified risk of material misstatement?
Discussion	Similar to definition of a relevant assertion, the outreach sessions suggested that certain definitions, including the definition of a significant class of transactions, account balance, or disclosure, are difficult to comprehend because they are difficult to navigate (that is, certain definitions build upon each other and multiple paragraphs need to be considered to understand them). The phrase "significant class of transactions, account balance, or disclosure" is consistent with the ISAs but also the phrase used in extant AU-C section 940. While some responders commented on the use of the term, the Task Force previously discussed with the Board (January 2020 meeting) the intent to retain this term as included in the proposed SAS and to consider the "interplay" between the definitions from a clarity perspective. The following table summarizes the definition of a significant class of transactions, account balance, or disclosure in comparison to PCAOB standards.

Proposed SAS and ISA 315 (Revised 2019)	PCAOB standards
Significant class of transactions, account balance, or disclosure. A class of transactions, account balance, or disclosure for which there is one or more relevant assertions.	**Significant account or disclosure.** An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The

	determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

Extant AU-C section 315 does not include a definition of a significant class of transactions, account balance, or disclosure and neither does extant AU-C section 940. Extant AU-C section 940, however, includes guidance related to risk factors that may be relevant to the identification of significant classes of transactions, account balances, and disclosures, which is consistent with PCAOB standards. With the introduction of inherent risk factors in the proposed SAS, conforming amendments were proposed to AU-C section 940. At the same time, additional guidance was carried forward from AU-Section 940 into the proposed SAS.

Preliminary view	The Task Force believes that the definition of a significant class of transactions, account balance, or disclosure could be clarified to address comments received as well as enhance the ease of understanding the definition. Due to other definitions and the structure of the requirements in the proposed SAS, it is not possible to adopt the PCAOB definition outright. Conceptually, however, the defined terms in the proposed SAS and PCAOB standards are the similar.
Proposed changes	**Significant class of transactions, account balance, or disclosure.** A class of transactions, account balance, or disclosure for which there is one or more relevant assertions. ***Accordingly, a significant class of transactions, account balance, or disclosure has an identified risk of material misstatement at the assertion level based on inherent risk.*** An alternative might be to include this proposed change in application material that is linked to the definition.
Questions for the Board	Does the Board agree with clarifying the definition of a significant class of transactions, account balance, or disclosure? If so, does the Board prefer the proposed change to the definition or the alternative to include the proposed change in application material?

IV. Clarifying the Concept of Reasonable Possibility

Issue	Should the auditor interpret the concept of "reasonable possibility" to mean more than remote?
Discussion	Comments received indicated that the term "reasonable possibility" is not sufficiently clear. More guidance was also requested to clarify where reasonable possibility lies on the spectrum of inherent risk.

	Paragraph .05 of the proposed SAS states: "For purposes of generally accepted auditing standards (GAAS), a risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude)." The proposed SAS does not define the term "reasonable possibility" nor does AU-C section 200. However, paragraph .07 of AU-C section 265 defines a material weakness and explains the concept of "reasonable possibility" as follows: "A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows: • **Reasonably possible.** The chance of the future event or events occurring is more than remote but less than likely. • **Probable.** The future event or events are likely to occur. It is the Task Force's understanding that this definition (and particularly the concept of "more than remote") is what is intended by ISA 315 (Revised 2019).
Preliminary view	The majority of the Task Force supports revisions to clarify the concept of "reasonable possibility" within the proposed SAS, as this concept is key to identifying and assessing risks of material misstatement. AU-C section 265 already defines the concept, so that description can be leveraged. It seems counterintuitive to not include similar guidance in the proposed SAS. However, the guidance in AU-C section 265 would not be comprehensible in the context of risk assessment, particularly if the proposed SAS retained the reference to "event or events" without further clarification.
Proposed changes	***Relevant Assertions*** A11. A risk of material misstatement may relate to more than one assertion, in which case, all the assertions to which such a risk relates are relevant assertions. For the purposes of the AU-C sections, a risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). ***Consequently, a reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is either probable (that is, likely to occur) or reasonably possible (that is, is more than remote but less than likely).*** If an assertion does not have an identified risk of material misstatement, then it is not a relevant assertion. The following includes other options that were considered:

	• *Consequently, a reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is either likely to occur or is more than remote but less than likely.* • *Consequently, a reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is more than remote.*
Questions for the Board	Does the Board agree with clarifying the concept of "reasonable possibility" within the proposed SAS? If so, does the Board agree with the proposed changes?

V. Audit Documentation Related to the Stand-Back Requirement

Issue	What audit documentation is required for the stand back requirement?
Discussion	The proposed SAS includes a new "stand-back" requirement (paragraph 36), which is intended to drive an evaluation of the completeness of the identification of significant classes of transactions, account balances, and disclosures by the auditor. This stand-back requirement is intended to focus on material classes of transactions, account balances, or disclosures that have not been determined to be significant (that is, the auditor has not identified any risks of material misstatement that are reasonably possible and, therefore, has not identified any relevant assertions). At its January 2021 meeting, the ASB discussed the issues presented in comment letters related to the stand-back requirement. The discussion focused on whether the stand-back requirement should be retained in the proposed SAS, given the issues raised. After discussion, the ASB decided to retain the stand-back requirement but instructed the Task Force to consider whether additional application material is necessary to clarify the requirement. The Task Force will consider the application material in future meetings, including concerns expressed with respect to the consideration of materiality at the overall financial statements or at the general ledger. A concern that was raised in comment letters and in outreach sessions related to audit documentation. It was suggested that the proposed SAS should be clearer in terms of the nature and extent of documentation that would be needed in relation to the stand-back requirement. It is noted that the proposed SAS currently includes the following guidance: **Documentation** A260. AU-C section 230, *Audit Documentation*, notes that among other considerations, although there may be no single way in which the auditor's

	exercise of professional skepticism is documented, the audit documentation may, nevertheless, provide evidence of the auditor's exercise of professional skepticism. For example, when the audit evidence obtained from risk assessment procedures includes evidence that both corroborates and contradicts management's assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in evaluating whether the audit evidence provides an appropriate basis for the auditor's identification and assessment of the risks of material misstatement. Examples of other requirements in this proposed SAS for which documentation may provide evidence of the exercise of professional skepticism by the auditor include the following: • Paragraph 36, which requires the auditor to evaluate, when applicable, whether the auditor's determination that there are no risks of material misstatement for a material class of transactions, account balance, or disclosure remains appropriate
Preliminary views	The Task Force believes that the form, content, and extent of the audit documentation is a matter of professional judgment and need not be extensive. Risk assessment in and of itself is an iterative and dynamic process. The stand-back requirement is a mindset to "challenge" whether the identified and assessed risks of material misstatement are appropriate in the circumstances (that is, to evaluate, when applicable, whether the auditor's determination that there are no risks of material misstatement for a material class of transactions, account balance, or disclosure remains appropriate). In addition, the audit methodology and tools used by the auditor, among other factors, may impact the related audit documentation. The Task Force considered the following additional guidance related to the stand-back requirement but determined that it may not add value and may not, in and of itself, be responsive to the comments received. In addition, the guidance, which already exists in AU-C section 230, would simply add to the length of the standard. ***As described in AU-C section 230, the form, content, and extent of audit documentation depends on various factors. The following factors, in particular, may be relevant in determining the form, content, and extent of audit documentation related to the evaluation required by paragraph .36:*** • ***the need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.*** • ***the audit methodology and tools used.*** • ***the extent of judgment involved in performing the evaluation.*** **Footnote:** Paragraph .A4 of AU-C section 230.

	Accordingly, the Task Force believes that the issue can be more appropriately addressed in the Basis of Conclusions document (see related issue), leveraging the guidance in AU-C section 230.
Questions for the Board	Does the Board agree that the form, content, and extent of the audit documentation related to the stand-back requirement is a matter of professional judgment and need not be extensive? If so, does the Board agree with addressing the issue raised by responders in the Basis of Conclusions document (assuming the Board agrees with issuing such a document; see related issue)?

VI. Spectrum of Inherent Risk

Issue	Should the application material include examples of how the spectrum of inherent risk may be applied in practice?
Discussion	Though implicit in extant audit literature, the spectrum of inherent risk was explicitly introduced in the proposed SAS to recognize (a) the degree to which inherent risk factors, individually or in combination, affect inherent risk to varying degrees, and (b) that inherent risk will be higher for some assertions than for others. With respect to this particular issue, responders to the comment letters questioned what is intended by the introduction of the spectrum of inherent risk. While some responders indicated this would not change practice, other responders indicated that the reference to higher or lower inherent risk may cause confusion and suggest that inherent risk may only consist of two categories. Stakeholders suggested, as part of the comment letters and outreach sessions, that additional guidance in the application material is needed to better illustrate the concept of the spectrum of inherent risk (for example, including examples of the schemes that would help operationalize the spectrum of inherent risk). The Task Force notes that the conforming amendments to AU-C section 200 include the following underlined guidance, which is also included in extant AU-C section 200. ~~**.A 44**~~ ***.A45*** GAAS ***typically*** ~~do not ordinarily~~ refer to ~~inherent risk and control risk separately, but rather to a combined assessment of~~ the risks of material misstatement***, rather than inherent risk and control risk separately***. However***, AU-C section 315 requires inherent risk to be assessed separately from control risk to provide a basis for designing and performing audit procedures to respond to the assessed risks of material misstatement at the assertion level.*** ~~the auditor may make separate or combined assessments of inherent and control risk depending~~

	~~on preferred audit techniques or methodologies and practical considerations.~~ The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made. It should be noted that the Task Force plans to consider other comments received with respect to the spectrum of inherent risk, which may result in additional application material to enhance clarity.
Preliminary views	The Task Force considered whether to include additional application material, such as the following in bold italics: **A236**. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within categories along the spectrum of inherent risk, based on their assessment of inherent risk. These ***inherent risk*** categories may be described in different ways***, such as by using a scale of inherent risk (for example, low, medium, or high; lower or higher; normal or elevated; or other type of nominal or arithmetic scale)***. Regardless of the method of categorization used, the auditor's assessment of inherent risk is appropriate when the design and implementation of further audit procedures to address the identified risks of material misstatement at the assertion level is appropriately responsive to the assessment of inherent risk and the reasons for that assessment. Concern was expressed that providing such examples may be too prescriptive and may not be consistent with certain audit methodologies that also contemplate significant risks. The Task Force ultimately concluded that the guidance in AU-C section 200 could be repeated in AU-C 315. In addition, examples could be provided in the Basis for Conclusions (see issue IX).
Proposed changes	The Task Force proposes the following changes: **A236**. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within categories along the spectrum of inherent risk, based on their assessment of inherent risk. These categories may be described in different ways, ***such as in quantitative terms (for example, in percentages) or in nonquantitative terms.*** Regardless of the method of categorization used, the auditor's assessment of inherent risk is appropriate when the design and implementation of further audit procedures to address the identified risks of material misstatement at the assertion level is appropriately responsive to the assessment of inherent risk and the reasons for that assessment.

	Footnote: Paragraph .A45 of AU-C section 200.
Questions for the Board	Does the Board agree with the proposed changes to paragraph .A236? Also, should additional examples of inherent risk "levels" be provided in the Basis for Conclusions (see issue IX)?

VII. New Basis for Conclusions Document

Issue	Should the ASB issue a Basis of Conclusions document concurrent with the final SAS?
Discussion	Responders to the Exposure Draft commented that the proposed SAS is too long, complex, and difficult to understand. The following are excerpts from the comment letters: • 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… • We are concerned that adopting the standard, as proposed, could exacerbate the execution challenges that currently exist in practice… • We believe the proposed SAS does clarify the applicable standards, but we also identified opportunities to improve conciseness and eliminate redundancies to strengthen the overall understandability… During the outreach sessions, we noted that certain aspects were better understood when additional supplementary explanations were provided to the stakeholders.
Preliminary views	The Task Force believes that additional implementation guidance will be necessary to be issued simultaneously with the final SAS; consideration will be given to the implementation guidance that is expected to be issued by the IAASB. Such implementation guidance could include a revised audit guide, flowcharts, and other visualizations. In addition to the implementation guidance, the Task Force believes that a Basis of Conclusions document could greatly enhance the understandability as well as implementation of the final SAS by providing additional transparency about the ASB's deliberations and decisions. This documentation could explain the objectives, rationale, and intent of key aspects of the final SAS. The IAASB historically has issued a Basis of Conclusions document alongside its auditing standards.

	The Task Force believes that AICPA staff could develop a proposed framework for such Basis of Conclusions document. In addition, the AITF could be requested to discuss the process for issuing such a document, including whether negative clearance is needed from the Board.
Proposed changes	Issue a Basis of Conclusions document together with the final SAS.
Questions for the Board	Does the Board agree with issuing the Basis of Conclusions document alongside the issuance of the final SAS? If so, does the Board agree with requesting the AICPA staff to develop a proposed framework for a Basis of Conclusions document and requesting the AITF to discuss the process related to issuance?

VIII. Timeline and final vote

During the March 2021 ASB teleconference, we plan to obtain the Board's views related to the timeline, including the vote to finalize the proposed SAS. A recommendation was made to move the vote from July 2021 to August 2021 to allow adequate time for new Board members to consider and form their views related to the proposed SAS. Another recommendation was made to keep the final vote in July 2021 (considering the effective date of the proposed SAS) but to add an additional conference call solely dedicated to the proposed SAS in June 2021.