



Agenda Item 2

Proposed SAS, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment

Objective of Agenda Item

To review the proposed SAS, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, which has been revised to take consideration of the issues identified in the comment letters, matters raised during outreach sessions, and feedback provided by the Auditing Standards Board (ASB or the Board) at the January and March meetings.

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

Background

On August 27, 2020, the 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 certain drafting recommendations that were evaluated by the Task Force.

At the January 2021 ASB meeting, the Board discussed the overall feedback received in the comment letters with a focus on the following:

- Matters that required the ASB’s strategic direction
- Matters raised by responders where the Task Force had some preliminary views

- Matters raised by responders to be addressed by the Task Force after the January 2021 ASB Meeting

The ASB discussed these matters and provided feedback and direction to the Task Force.

At the March 10, 2021 ASB meeting, the Board discussed the following matters and provided feedback to the Task Force.

- **Understanding Processes and Controls Related to Journal Entries**—The ASB agreed that paragraph 26(a)(ii) (temporarily renumbered as 26Ab) is intended to cover the extant requirement in paragraph 32(a)(i) in AU-C section 240. It was noted that the extant requirement in AU-C section 240 is an incremental US GAAS requirement in comparison to ISA 240. Accordingly, the ASB agreed to not make the proposed edits suggested by the Task Force but requested the Task Force to align the requirements between the proposed SAS and AU-C section 240.
- **Definition of Relevant Assertion**—The ASB agreed with the option supported by the majority of the Task Force, which combines the definition in the proposed SAS with its related application material. This is because the definition of a relevant assertion in the proposed SAS and its application material were taken from ISA 315 (Revised 2019) and using language from ISA 315 (Revised 2019) could avoid any potential inconsistencies within the proposed SAS.
- **Definition of a Significant Class of Transactions, Account Balance, or Disclosure**—The ASB directed the Task Force to consider adding application material (rather than making changes to the definition). The guidance would connect the definition of a significant class of transactions, account balance, or disclosure to a risk of material misstatement at the assertion level (and a relevant assertion).
- **Clarifying the Concept of Reasonable Possibility**—The ASB debated the options provided by the Task Force and various views were expressed, particularly with respect to use of the term “remote.” After discussion, the ASB directed the Task Force to consider adding application material but reconsider the various options proposed based on ASB feedback.
- **Audit Documentation Related to the Stand-Back Requirement**—The ASB agreed that this matter could be better addressed in the Audit Guide.
- **Spectrum of Inherent Risk**—The ASB directed the Task Force to consider adding application material that would illustrate a non-quantitative scheme to assess the spectrum of inherent, for example “high, medium, low.” This would be in addition to the quantitative scheme example in AU-C section 200 (that is, the use of percentages).

After a discussion about the timeline of the proposed SAS with the ASB, the Task Force intends to bring the proposed SAS for a final vote in August 2021. The proposed timeline is intended to enable the proposed SAS to be effective for audits of financial statements for periods ending on or after December 15, 2023, which coincides with the effective date of SAS No. 143, *Auditing Accounting Estimates and Relates Disclosures*.

The Risk Assessment Task Force met on March 25-26, April 8-9, and April 26, 2021 to continue evaluating the comment letters received. The issues presented below represent the issues underlying certain edits made to the proposed SAS that the Task Force identified for discussion with the ASB.

Agenda Materials

Agenda Item 2: Risk Assessment Discussion Memorandum and Issues for Consideration

Agenda Item 2A: Proposed SAS, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, marked from the Exposure Draft

Agenda item 2B: Comparison Matrix of Requirement Paragraphs, which includes the proposed SAS marked from ISA 315 (Revised 219), extant AU-C section 315, and AS 2110, *Identifying and Assessing the Risks of Material Misstatement*

Ms. Manasses will use Item 2 and 2A in leading the discussion. Please note that the Task Force has not completed its review of the appendices of the proposed SAS and will not discuss those sections at this meeting.

Issues for Consideration

The following summarizes the issues for the Board’s consideration. Each issue has been identified within the proposed SAS. Accordingly, the discussion will start with the proposed SAS, focusing on the issues and other significant changes.

It is important to note that the Task Force has not completed its deliberation of comment letters, particularly with respect to considerations related to governmental entities as well as the comments related to the appendices. In addition, the Task Force has several other matters pending discussion that will be brought to the next Board meeting.

A. Spectrum of Inherent Risk

Issue	Should a definition of the spectrum of inherent risk be included in the proposed SAS?
Discussion	Paragraph 5 of the proposed SAS explains that inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. It further explains that “The degree to which inherent risk varies is referred to in this proposed SAS as the <i>spectrum of inherent risk</i> .” The source of this statement is a conforming amendment to AU-C section 200 proposed in the Exposure Draft. A responder to the Exposure Draft (NASBA) suggested a definition of the <i>spectrum of inherent risk</i> be included in the proposed SAS. This is consistent with other comments received during the exposure period and outreach sessions that called for more clarity surrounding certain definitions.
Preliminary views	<p>The Task Force discussed that the definitions and explanations of the audit risk model, including the definition of inherent risk are included in AU-C section 200. The Task Force debated whether a separate definition of the spectrum of inherent risk be included in either AU-C section 200 or in the proposed SAS. However, the Task Force concluded that a standalone definition was not constructive.</p> <p>The Task Force noted that the conforming amendment to AU-C section 200 links the spectrum of inherent risk to inherent risk factors. Thus, the Task Force concluded to modify the definition of inherent risk factors in the proposed SAS to align the definition to the conforming amendment proposed to AU-C section 200.</p>
Proposed changes	<p>The Task Force proposes the following change to paragraph 12 (<i>boldface italics</i> denotes new language):</p> <p style="padding-left: 40px;">Inherent risk factors. Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or</p>

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	<p>other fraud risk factors¹ insofar as they affect inherent risk.</p> <p><i>Depending on the degree to which the inherent risk factors affect the susceptibility to misstatement of an assertion, the level of inherent risk varies on a scale that is referred to as the spectrum of inherent risk.</i></p>
Questions for the Board	Does the ASB agree with the revision proposed by the Task Force to the definition of inherent risk factors to include the spectrum of inherent risk, aligning the definition with the conforming amendment proposed to AU-C section 200?

B. Evaluation of Internal Control Components (Excluding Control Activities)

Issue	<p>What does “evaluate” mean in the context of obtaining an understanding of the control environment, the entity’s risk assessment process, the information system and communication, and the entity’s process to monitor the system of internal control? In addition, how does such evaluation impact the audit?</p> <p>Further, is inquiry alone sufficient to obtain an understanding and to evaluate the control environment, the entity’s risk assessment process, and the entity’s process to monitor the system of internal control?</p>
Discussion	<p>As explained in the Issues Paper presented at the January 2021 ASB meeting, responders expressed a concern that the work effort related to the components of internal control is not clear due to the difference of how the requirements for the more indirect controls and the more direct controls are articulated (that is, obtain an understanding and evaluate the component versus evaluate design and determine implementation of controls that address risks of material misstatement).</p> <p>While there was overall support for the requirement in paragraph 26d (temporarily renumbered as 26C) of the proposed SAS to evaluate design and determine implementation of certain control activities, the Task Force and the Board recognized the need to clarify the requirement to evaluate the matters specified in the requirements (paragraphs 21b, 22b, 24b, and 25c) related to the control environment, the entity’s risk assessment process, the information system and communication, and the entity’s process to monitor the system of internal control?</p> <p>It is important to note that ISA 315 (Revised 2019) indicates, within the application material, that the required evaluation is based on the auditor’s understanding. ISA 315 (Revised 2019) further illustrates this by using a tabular</p>

¹ Paragraphs .A28–.A32 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.

presentation within the requirements section, whereby the specific requirements related to the understanding are on the left and the requirements related to the evaluation are on the right. Collectively, such requirements encompass the auditor's understanding of the component for purposes of performing an audit in accordance with the ISAs. The proposed SAS does not include such tabular presentation.

PCAOB standards

Further, similar to extant AU-C section 315, paragraph 20 of AS 2110, *Identifying and Assessing the Risks of Material Misstatement*, indicates that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

The adopting release, PCAOB Release No. 2010-004, states the following:

Some commenters expressed concern that the language in the requirement could be misinterpreted as requiring the auditor to obtain an understanding of all controls, even in an audit of financial statements only in which the auditor does not plan to test controls. A few commenters suggested framing the requirement in terms of understanding control activities relevant to the audit. The Board did not intend to expand the auditor's responsibilities for obtaining an understanding of control activities beyond what is required in AU sec. 319. The discussion in Auditing Standard No. 12 on obtaining an understanding of control activities (*paragraph 34*) has been revised, primarily using language adapted from AU sec. 319, to clarify that the substance of the requirement has not changed.

Paragraph .34 of AS 2110 states:

.34 The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph .18 of this standard.18 As the auditor obtains an understanding of the other components of internal control over financial reporting, he or she is also likely to obtain knowledge about some control activities. The auditor should use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures.

Note: A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the auditor's

understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

In addition, a note to paragraph .24 of AS 2110 states the following, which differentiates the work effort related to the control environment in a financial statement only audit versus and audit of internal control over financial reporting:

Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph .23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, AS 2201 describes the auditor's responsibility for evaluating the control environment.

AU-C section 319

It is also important to note the guidance in AU-C section 319, as adopted by the PCAOB as an interim standard and referenced in the adopting release of Auditing Standard No. 12. Paragraph .14 of AU-C section 319 states the following:

.14 The division of internal control into five components provides a useful framework for auditors to consider the impact of an entity's internal control in an audit. However, it does not necessarily reflect how an entity considers and implements internal control. Also, the auditor's primary consideration is whether a specific control affects financial statement assertions rather than its classification into any particular component. ***Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions.*** Such controls may exist in any of the five components.

Inquiry alone

The Exposure Draft of the proposed SAS stated the following:

A99. Risk assessment procedures to obtain an understanding of the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control include a combination of inquiry, observation, and inspection, as required by paragraph 14. ***Inquiry alone is not sufficient to obtain an understanding of or to evaluate each of these components as required by this proposed SAS.***

The language in ***boldface italics*** was added by the Board and does not exist in ISA 315 (Revised 2019). Procedures beyond inquiry are only required to evaluate design and determine implementation. There is no specific requirement in the

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	<p>proposed SAS that requires procedures beyond inquiry to obtain an understanding of and to evaluate the control environment, the entity’s risk assessment process, and the entity’s process to monitor the system of internal control. However, the language infers such.</p>
<p>Preliminary views</p>	<p>The Task Force proposes to retain the requirements to evaluate the matters specified in the requirements (paragraphs 21b, 22b, 24b, and 25c) related to the control environment, the entity’s risk assessment process, the information system and communication, and the entity’s process to monitor the system of internal control. This includes not requiring the auditor to evaluate the design and determine the implementation of controls within these components for purposes of performing the required evaluation. However, the Task Force proposes a clarification of the requirements as well as additional application material, as there is a difference in the work effort to perform the evaluation required by the aforementioned paragraphs and to evaluate the design of an identified control. The latter would necessitate a more in-depth evaluation as to whether the control meets the control objective.</p> <p>To clarify the requirements, the Task Force suggests elevating application material. The application material more clearly indicates that the required evaluation is “based on the auditor’s understanding.” Including this language within the requirements further clarifies the intent of the requirement. Such language also achieves similar clarity as the tabular presentation in ISA 315 (Revised 2019).</p> <p>With respect to the application material, the Task Forces suggests additional guidance to clarify that controls within these components may be controls for which the auditor also evaluates design and determines implementation, which is consistent with ISA 315 (Revised 2019), PCAOB standards, and AU-C section 319 (pre-clarity). While such guidance was already included in the proposed SAS, the Task Force reconsidered the placement of the guidance as well as its clarity. The Task Force is also suggesting certain additional guidance to address how the evaluation may impact the audit.</p> <p>Further, the Task Force suggests adding application material, adapted from PCAOB standards, that specifically addresses the nature, timing, and extent of procedures that are necessary to obtain an understanding of the entity’s system of internal control. In addition, the Task Force suggests modifying the application material to indicate that inquiry alone may be sufficient, which may be the case, for example, for certain less complex entities or for a continuing audit engagement. These changes eliminate the implicit requirement in the application material.</p>
<p>Proposed changes</p>	<p>Clarification of the requirements</p>

The following illustrates the change proposed to paragraph 21 (*boldface italics* denotes new language). A similar change is being proposed to paragraphs 22b, 24b, and 25c.

21. The auditor should, through performing risk assessment procedures, obtain an understanding of the control environment relevant to the preparation of the financial statements by (Ref: par. A111– A112)

- a. understanding the set of controls, processes, and structures that address (Ref: par. A113)
 - i. how management’s oversight responsibilities are carried out, such as the entity’s culture and management’s commitment to integrity and ethical values;
 - ii. when those charged with governance are separate from management, the independence of, and oversight over the entity’s system of internal control by, those charged with governance;
 - iii. the entity’s assignment of authority and responsibility;
 - iv. how the entity attracts, develops, and retains competent individuals;
 - v. how the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control; and
- b. evaluating, *based on the auditor’s understanding obtained in paragraph 21a*, whether (Ref: par. A114–A119)
 - i. management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior;
 - ii. the control environment provides an appropriate foundation for the other components of the entity’s system of internal control considering the nature and complexity of the entity; and
 - iii. control deficiencies identified in the control environment undermine the other components of the entity’s system of internal control.

Application material

Refer to the following paragraphs in the proposed SAS for proposed revisions to the application material:

- Paragraphs A98 to A101, which address the auditor’s understanding and evaluation of the components of internal control as well as evaluating the design and determining the implementation of identified controls

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	<ul style="list-style-type: none"> • Paragraphs A114, A123, A134, and A160, which specifically address the evaluation related to each component (excluding the control activities component); also refer to Issue D with respect to the information system and communication component • Paragraphs A113, A123A, A133, which address how the evaluation of the control environment, entity’s risk assessment process, and entity’s process to monitor the system of internal control may impact the audit.
<p>Questions for the Board</p>	<p>Does the ASB agree with:</p> <ul style="list-style-type: none"> • The proposed changes to the requirements in paragraphs 21b, 22b, 24b, and 25c to include the “based on the auditor’s understanding” language from the application material to clarify the work effort to “evaluate” the control environment, the entity’s risk assessment process, the entity’s process to monitor the system of internal control, and the information system and communication? • The revised application material in paragraphs A198 to A101 as well as paragraphs A114, A123, and A134 to clarify the work effort to “evaluate” the components of internal control and to better clarify when the auditor may evaluate design and determine implementation of controls within the control environment, the entity’s risk assessment process, and the entity’s process to monitor the system of internal control? See Issue D with respect to paragraph A160. • The revised application material in paragraphs A113, A123A, and A133 to further clarify how the evaluation of the control environment, entity’s risk assessment process, and entity’s process to monitor the system of internal control may impact the audit? <p>In addition, does the ASB agree with the revisions to indicate that inquiry alone may be sufficient, or does the ASB believe that the application material needs to be elevated to a requirement?</p>

C. The Entity’s Risk Assessment Process and Interplay with AU-C section 240

<p>Issue</p>	<p>Should the requirement to obtain an understanding of the entity’s risk assessment process be clarified to more clearly address the entity’s assessment of fraud risks to align with AU-C section 240 and COSO’s 2013 <i>Internal Control—Integrated Framework</i> (COSO framework)?</p>
<p>Discussion</p>	<p>Paragraph 22 of the proposed SAS reads, in part, as follows:</p>

22. The auditor should, through performing risk assessment procedures, obtain an understanding of the entity’s risk assessment process relevant to the preparation of the financial statements by

- a. understanding the entity’s process for (Ref: par. A120–A122)
 - i. identifying business risks relevant to financial reporting objectives; (Ref: par. A69)...

Paragraph 17 of AU-C section 240 states the following:

.17 The auditor should make inquiries of management regarding

- a. **management’s assessment of the risk that the financial statements may be materially misstated due to fraud, [emphasis added]** including the nature, extent, and frequency of such assessments; (Ref: par. .A14–.A15)
- b. management’s process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: par. .A16)...

The proposed SAS includes the following application material:

A121. Paragraph 22 of this proposed SAS requires the auditor to obtain an understanding of the entity’s process for identifying business risks. AU-C section 240² requires the auditor to make inquiries of management regarding, among other things, management’s process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist.

This application material is not included in ISA 315 (Revised 2019). It was added to the proposed SAS to align with the requirements in AU-C section 240. Responders commented on the alignment of the components and principles in the COSO Framework with the requirements in the proposed SAS, specifically identifying the entity’s risk assessment process.

With respect to the risk assessment component, the COSO Framework includes the following principle:

- 8. The organization considers the potential for fraud in assessing risks to the achievement of the objectives.

Similarly, the U.S. Government Accountability Office’s *Standards for Internal Control in the Federal Government* (the “Green Book”) includes the following principle:

² Paragraph .17 of AU-C section 240.

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	8. Management should consider the potential for fraud when identifying, analyzing, and responding to risks.
Preliminary views	The Task Force suggests clarifying the requirement in paragraph 22 to specifically refer to understanding the entity’s process for identifying the potential for fraud. This will not only align with the requirements in AU-C section 240 but also with the COSO Framework and the Green Book.
Proposed changes	<p>The Task Force’s suggests the following edit to paragraph 22 of the proposed SAS (<i>boldface italics</i> denotes new language):</p> <p style="padding-left: 40px;">22. The auditor should, through performing risk assessment procedures, obtain an understanding of the entity’s risk assessment process relevant to the preparation of the financial statements by</p> <p style="padding-left: 80px;"><i>b.</i> understanding the entity’s process for (Ref: par. A120–A122)</p> <p style="padding-left: 80px;"><i>ii.</i> identifying business risks, <i>including the potential for fraud</i>, relevant to financial reporting objectives; (Ref: par. A69)...</p> <p>No changes are being proposed to the application material in paragraph A121, which links the requirement in paragraph 22 to AU-C section 240.</p>
Questions for the Board	Does the ASB agree with the suggested edits to align AU-C section 315 with AU-C section 240, the COSO Framework, and the Green Book with respect to the entity’s risk assessment process related to fraud risks?

D. Evaluation of the Information System and Communication

Issue	With respect to the information system and communication component, what does it mean to “evaluate whether the entity’s information system and communication appropriately support the preparation of the entity’s financial statements in accordance with the applicable financial reporting framework” and is such evaluation performed considering the nature and complexity of the entity?
Discussion	<p>When obtaining an understanding of the entity’s information system and communication relevant to the preparation of the financial statements, paragraph 25c requires the auditor to evaluate whether the entity’s information system and communication appropriately support the preparation of the entity’s financial statements in accordance with the applicable financial reporting framework.</p> <p>Issue B addresses the Task Force’s general response to clarify the “work effort” involved in performing the evaluation required by paragraph 25c. However, with respect to the information system and communication</p>

	<p>component, the Task Force discussed whether additional guidance was necessary to further clarify the auditor’s responsibilities. ISA 315 (Revised 2019) and the proposed SAS do not elaborate what such evaluation might entail or what might be the result of such evaluation.</p> <p>In addition, the Task Force noted that the requirements to evaluate the control environment, the entity’s risk assessment process, and the entity’s process for monitoring the system of internal control in paragraphs 21b, 22b, and 24b specifically refer to considering the nature and complexity of the entity. However, reference to the consideration of the nature and complexity of the entity is not made in paragraph 25c.</p> <p>COSO framework</p> <p>A couple of respondents to the exposure draft generally indicated a misalignment between the COSO principles and the proposed SAS. It is important to note, however, that the proposed SAS was not intended to specifically align with COSO. The proposed SAS is framework neutral but includes elements of internal control frameworks that are relevant to an audit of financial statements.</p> <p>COSO includes the following three principles relating to Information and Communication:</p> <ul style="list-style-type: none"> • The organization obtains or generates and uses relevant, quality information to support the functioning of internal control • The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control • The organization communicates with external parties regarding matters affecting the functioning of internal control.
<p>Preliminary views</p>	<p>The Task Force believes that considering the nature and complexity of the entity is equally applicable to the information system and communication component. The Task Force also believes that additional application material may be necessary to clarify the auditor’s responsibilities related to the evaluation of such component. A member of the task force believes that a requirement to evaluate whether the entity’s information system and communication appropriately support the preparation of the entity’s financial statements in accordance with the applicable financial reporting framework can be taken out of context without such application materiality. The Task Force, however, is concerned about developing application material that may also be misinterpreted.</p> <p>The Task Force considered the following two options (<i>boldface italics</i> denotes new language considered) but ultimately concluded to add guidance that refers to Appendix C, which further describes the information system and communication component. The concern with Option 1 is that the example relates to each significant class of transactions, account balance, or disclosure, while the evaluation is intended to address the component. While</p>

	<p>Option 2 introduces guidance from COSO, including the COSO principles, concern was expressed with respect to whether this was the intent of the evaluation required by ISA 315 (Revised 2019).</p> <p>Option 1</p> <p>A160. The auditor’s evaluation of whether the entity’s information system and communication appropriately supports the preparation of the financial statements is based on the understanding obtained in paragraph Error! Reference source not found.a–b. <i>For example, as the auditor understands how information flows through the entity’s information system, the auditor determines whether the entity’s information processing activities for each significant class of transactions, account balance, and disclosure are adequate to allow the entity to prepare the financial statements, considering the nature and complexity of the entity and its financial reporting framework.</i></p> <p>Option 2</p> <p>A160. The auditor’s evaluation of whether the entity’s information system and communication appropriately supports the preparation of the financial statements is based on the understanding obtained in paragraph 25a–b.</p> <p><i>A160A. Information is necessary for the entity to carry out responsibilities that support the achievement of its financial reporting objectives. Management obtains or generates and uses relevant and quality information from both internal and external sources to support the functioning of the entity’s system of internal control relevant to the preparation of financial statements. Communication is the continual, iterative process of providing, sharing, and obtaining such information. Accordingly, with respect to the evaluation required by paragraph 25c, the auditor may consider, based on the auditor’s understanding, whether:</i></p> <ul style="list-style-type: none"> • <i>The entity obtains or generates and uses relevant, quality information with respect to the entity’s information-processing activities for significant classes of transactions, account balances, or disclosures</i> • <i>The entity internally communicates information, including financial reporting roles and responsibilities, necessary to support the functioning of the entity’s system of internal control relevant to the preparation of financial statements</i> • <i>The entity communicates with external parties regarding significant matters affecting the functioning of the entity’s system of internal control relevant to the preparation of financial statements.</i>
<p>Proposed changes</p>	<p>The Task Force suggests the following change to paragraph 25c to refer to the nature and complexity of the entity (<i>boldface italics</i> denotes new language); see Issue B with respect to the inclusion of the phrase “based on the auditor’s understanding”:</p> <p>25. The auditor should...</p> <p>c. Evaluating, <i>based on the auditor’s understanding obtained in paragraph 25a-25b</i>, whether the entity’s information system and</p>

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	<p>communication appropriately support the preparation of the entity’s financial statements in accordance with the applicable financial reporting framework <i>considering the nature and complexity of the entity</i>. (Ref: par. A161).</p> <p>The Task Force also proposes including the following application material to paragraph A160 (<i>boldface italics</i> denotes new language) :</p> <p>A160. The auditor’s evaluation of whether the entity’s information system and communication appropriately supports the preparation of the financial statements is based on the understanding obtained in paragraph Error! Reference source not found.<i>a–b</i>. The evaluation is focused on the matters addressed in paragraph 25b, and therefore, does not require evaluating the design or determining the implementation of individual controls within the information system and communication. Appendix C3 sets out further considerations relating to the information system and communication component.</p>
<p>Questions for the Board</p>	<p>Does the ASB agree with the proposed edit to paragraph 25c to include reference to the nature and complexity of the entity?</p> <p>Does the ASB agree with the additional application material in paragraph A160 to further clarify the auditor’s responsibilities related to the evaluation required by paragraph 25c?</p>

E. Separating the Requirements Related to Control Activities

<p>Issue</p>	<p>Should paragraph 26 of the proposed SAS be restructured (into separate paragraphs) to enhance its clarity and readability?</p>
<p>Discussion</p>	<p>Paragraph 26 of the proposed SAS reads as follows:</p> <p><i>Control Activities</i></p> <p>26. The auditor should, through performing risk assessment procedures, obtain an understanding of the control activities component by (Ref: par. A162–A173)</p> <ul style="list-style-type: none"> a. identifying controls that address risks of material misstatement at the assertion level in the control activities component as follows: <ul style="list-style-type: none"> 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 nonrecurring, unusual transactions, or adjustments (Ref: par. A176–A177) iii. Controls for which the auditor plans to test operating effectiveness in

³ Paragraphs 15–16 of appendix C.

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	<p>determining the nature, timing, and extent of substantive testing, which should include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (Ref: par. A178–A180)</p> <p>iv. Other controls that the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level, based on the auditor’s professional judgment (Ref: par. A181–A182)</p> <p>b. based on controls identified in (a), identifying the IT applications and the other aspects of the entity’s IT environment that are subject to risks arising from the use of IT (Ref: par. A183–A190).</p> <p>c. for such IT applications and other aspects of the IT environment identified in (b), identifying (Ref: par. A191–A193)</p> <p>i. the related risks arising from the use of IT, and</p> <p>ii. the entity’s general IT controls that address such risks.</p> <p>d. for each control identified in a or c(ii) (Ref: par. A194–A202)</p> <p>i. evaluating whether the control is designed effectively to address the risk of material misstatement at the assertion level or effectively designed to support the operation of other controls</p> <p>ii. determining whether the control has been implemented by performing procedures in addition to inquiry of the entity’s personnel.</p> <p>While various comments were received with respect to paragraph 26, it was noted that the requirement, as drafted, is cumbersome. Such drafting may create unnecessary complexity and also impacts understandability.</p>
Preliminary views	<p>To enhance clarity and readability, the Task Force suggests restructuring paragraph 26. Such restructuring is responsive to comments related to complexity.</p>
Proposed changes	<p>The Task Force suggests restructuring paragraph 26 into separate paragraphs as follows. The proposed language below also includes other edits proposed by the Task Force (refer to Agenda Item A for tracked changes).</p> <p><i>Control Activities</i></p> <p>26. The auditor should, through performing risk assessment procedures, obtain an understanding of the control activities component, by applying paragraphs 26A–26C. (Ref: par. A162–A173)</p> <p>26A. The auditor should identify the following controls that address risks of material misstatement at the assertion level:</p> <p>a. Controls that address a risk that is determined to be a significant risk (Ref: par. A174–A175)</p> <p>b. Controls over journal entries and other adjustments as required by AU-C</p>

	<p>section 240⁴ (Ref: par. A176–A177)</p> <p><i>c.</i> Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which should include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (Ref: par. A178–A180)</p> <p><i>d.</i> Other controls that, based on the auditor’s professional judgment, the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level. (Ref: par. A181–A182)</p> <p>26B Based on controls identified in 26A, the auditor should identify the IT applications and the other aspects of the entity’s IT environment that are subject to risks arising from the use of IT. For such IT applications and other aspects of the IT environment, the auditor should identify (Ref: par. A183–A193)</p> <p><i>a.</i> the related risks arising from the use of IT, and</p> <p><i>b.</i> the entity’s general IT controls that address such risks.</p> <p>26C For each control identified in paragraph 26A or 26B<i>b</i>, the auditor should: (Ref: par. A194–A202)</p> <p><i>a.</i> evaluate whether the control is designed effectively to address the risk of material misstatement at the assertion level or effectively designed to support the operation of other controls</p> <p><i>b.</i> determine whether the control has been implemented by performing procedures in addition to inquiry of the entity’s personnel.</p> <p>Also, the following noteworthy edits were made to new paragraph 26A of the proposed SAS:</p> <p><i>a.</i> Eliminated “in the control activities component” as it is addressed in paragraph 26 and improves readability. In addition, “controls” in other components may address risks of material misstatement (see Issue B).</p> <p><i>b.</i> Changed “as follows” to “the following” so as not to infer that all controls related to assertion level risks need to be identified. This was a comment provided in response to the Exposure Draft.</p>
<p>Questions for the Board</p>	<p>Does the ASB agree with the restructuring of paragraph 26 into separate paragraphs to enhance its clarity and readability?</p> <p>Does the ASB agree with the other edits made to paragraph 26A?</p>

F. Controls over Journal Entries

⁴ Paragraph 32(a)(i) of AU-C section 240.

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Issue	To what extent is the auditor required to understand controls over journal entries?
Discussion	<p>As discussed at the March 10, 2021 ASB Meeting, several responders commented on the requirement in paragraph .26(a)(ii) (temporarily renumbered as 26Ab) 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:</p> <ul style="list-style-type: none"> • 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. <p>After a lengthy discussion, the ASB agreed that paragraph .26(a)(ii) (temporarily renumbered as 26Ab) is intended to cover the requirement in paragraph 32(a)(i) in AU-C section 240, which is incremental to ISA 240. Accordingly, the ASB agreed to not make the proposed edits previously suggested by the Task Force but requested the Task Force to align the requirements between the proposed SAS and AU-C section 240.</p>
Preliminary views	<p>The Task Force accepted the ASB’s recommendation and, in response, is suggesting edits to new paragraph 26Ab as well as conforming amendments to AU-C section 240. With respect to such changes, it is important to note the following:</p> <ul style="list-style-type: none"> • Since AU-C section 240 contains the “original” requirement (which referenced paragraph 19f of extant AU-C section 315) as well as more extensive guidance related to journal entries and other adjustments, the requirement to understand controls over such journal entries and other adjustments was retained therein • A reference to the requirement in AU-C section 240 was retained in AU-C section 315 to not only achieve consistency with ISA 240 but to also facilitate compliance with the requirement in paragraph 26B • AU-C section 240 was revised to align with the language in paragraph 26C with respect to evaluating design and determining implementation • AU-C section 240 was also revised to include the language in the proposed SAS and paragraph 19f of extant AU-C section 315, which refers to nonstandard journal entries; however, the reference to “nonrecurring, unusual transactions” was replaced with “significant unusual transactions” as defined by AU-C section 240

<p>Proposed changes</p>	<p>The Task Force is proposing the following edits to new paragraph 26Ab (<i>boldface italics</i> denotes new language; deleted text is shown in strikethrough):</p> <p>26A. The auditor should identify the following controls that address risks of material misstatement at the assertion level:</p> <ul style="list-style-type: none"> a. Controls that address a risk that is determined to be a significant risk (Ref: par. A174–A175) b. Controls over journal entries <i>and other adjustments as required by AU-C section 240⁵</i>, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments (Ref: par. A176–A177) <p>In addition, the Task Force suggests the following conforming amendments to AU-C section 240 (<i>boldface italics</i> denotes new language; deleted text is shown in strikethrough):</p> <p>AU-C section 240, Consideration of Fraud in a Financial Statement Audit</p> <p>.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</p> <ul style="list-style-type: none"> 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, <i>including controls over nonstandard journal entries used to record significant unusual transactions, and evaluate the suitability of design and determine whether the controls have been implemented</i> implementation of such controls¹² ... <p style="text-align: center;">^{fn 12} <i>Paragraph 26Ab</i></p>
<p>Questions for the Board</p>	<p>Does the ASB agree with the edits made to paragraph 26Ab and AU-C section 240 to respond to the ASB feedback at the March 10, 2021 ASB meeting?</p>

G. Assessing Control Risk

⁵ Paragraph 32(a)(i) of AU-C section 240.

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Issue	<p>Should paragraph 34 of the proposed SAS, which addresses the auditor’s assessment of control risk, be revised based on comments received?</p> <p>In addition, is additional application material necessary to further clarify how the auditor’s evaluation of design and determination of implementation may inform the nature, timing, or extent of substantive procedures, particularly when tests of controls are not performed?</p>
Discussion	<p>Paragraph 34 of the proposed SAS states the following:</p> <p style="padding-left: 40px;">If the auditor plans to test the operating effectiveness of controls, the auditor should assess control risk. If the auditor does not plan to test the operating effectiveness of controls, the auditor’s assessment of control risk should be such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk. (Ref: par. A248–A252)</p> <p>As more fully explained in the Issues Paper presented to the ASB at its January 2021 meeting, while supporting the general direction of the assessment of control risk set out in paragraph 34 of the proposed SAS, responders provided specific comments to improve the clarity of the requirement. In addition, there were four responders that did not support paragraph 34 of the proposed SAS. The Appendix to this Issues Paper reproduces the section of the January 21 ASB Issues Paper that summarizes the comments that deal with this topic.</p> <p>While comments seem to imply a lack of understanding of the requirement in paragraph 34, some responders also commented on only assessing control risk when the auditor plans to test operating effectiveness.</p> <p>It is important to note that paragraph A71 of SAS No. 143, <i>Auditing Accounting Estimates and Relates Disclosures</i>, states the following:</p> <p style="padding-left: 40px;">A71. The auditor’s assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, or minimum) or in terms of the auditor’s expectation of how effective the controls are in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.</p> <p>It is also important to note that PCAOB standards state the following with respect to control risk:</p> <ul style="list-style-type: none">• AS 2110 (paragraph 39) – Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming an opinion about the effectiveness of internal control over financial reporting.

	<ul style="list-style-type: none">• AS 2301 (paragraph 16) – If the auditor plans to assess control risk at less than the maximum by relying on controls, and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance. However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions and, for a variety of reasons, the auditor may choose not to do so. <p>Other comments were focused on the clarity of the guidance related to how the auditor’s evaluation of design and determination of implementation informs the auditor’s further audit procedures when tests of controls are not performed.</p>
Preliminary views	<p>In response to the comments related to the requirement in paragraph 34, the Task Force considered the following alternatives:</p> <ul style="list-style-type: none">• Option 1 – If the auditor plans to test the operating effectiveness of controls, the auditor should assess control risk. If the auditor does not plan to test the operating effectiveness of controls or the auditor concludes the controls are not operating effectively, the auditor assesses the risk of material misstatement to be the same as the assessment of inherent risk.• Option 2 – If the auditor plans to test the operating effectiveness of controls, the auditor should assess control risk. If the auditor does not plan to test the operating effectiveness of controls, the auditor’s assessment of the risk of material misstatement is the same as the assessment of inherent risk and cannot be reduced by the control risk assessment.• Option 3 – For identified risks of material misstatement at the assertion level, the auditor should assess control risk based on the auditor’s understanding of controls and the auditor’s plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the auditor should not assess control risk at less than maximum (<i>or should assess control risk at maximum</i>). <p>After discussion, the Task Force decided not to amend the requirement largely in the interest of convergence. However, the Task Force found merits in the alternatives and agreed to provide further guidance in the application material, consistent with SAS No. 143.</p> <p>Evaluation of design and determination of implementation guidance</p> <p>Paragraph A137 states that, even when the auditor does not plan to test the operating effectiveness of identified controls, the auditor’s understanding may still affect the design of the nature, timing, and extent of substantive procedures that are responsive to the related risks of material misstatement. The Appendix to</p>

	<p>this Issues Paper identifies additional paragraphs in the proposed SAS that provide further guidance with respect to this matter.</p> <p>Most of the examples in the proposed SAS pertain to situations in which controls are not designed effectively or implemented. In such cases, the auditor might not identify controls in accordance with paragraph 26A or might identify controls and not determine implementation because the auditor concludes that controls are not designed effectively. However, there may be circumstances in which controls are designed effectively and implemented.</p> <p>With respect to the issue of how the auditor’s evaluation of design and determination of implementation informs the nature, timing or extent of substantive procedures, a member of the Task Force feels strongly about the need for additional guidance. If the determination of a significant class of transactions, account balance, or disclosure is based on inherent risk (that is, before consideration of controls) and control risk is generally assessed at maximum when the auditor does not plan to perform tests of controls, then it is important to clarify how the evaluation of design and determination of implementation of identified controls may impact the audit. While the response to the identified and assessed risks of material misstatement is outside the scope of the proposed SAS, the guidance included in the Exposure Draft could be further clarified and expanded to address this matter. This is not intended to imply a “reduction” in the substantive procedures to be performed, as there is no “minimum” nature, timing, or extent imposed by US GAAS (other than with respect to external confirmations); however, this may influence the persuasiveness of the audit evidence to be obtained. This is also important so as an auditor does not inappropriately infer that the effective design and implementation of identified controls may be taken into account in the identification of significant classes of transactions, account balances, and disclosures and their relevant assertions.</p>
<p>Proposed changes</p>	<p>The Task Force is proposing the following edits to paragraph A248 to provide additional guidance related to control risk (<i>boldface italics</i> denotes new language):</p> <p style="padding-left: 40px;">A248. The auditor’s assessment of control risk may be performed in different ways, depending on preferred audit techniques or methodologies, and may be expressed in different ways. <i>For instance, the control risk assessment may be expressed using qualitative terms (such as control risk assessed as maximum, moderate, or minimum) or in terms of the auditor’s expectation of how effective the controls are in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls. In accordance with paragraph 34, tests of the operating effectiveness of controls are required to support a control risk assessment below the maximum level.</i></p> <p>The Task Force also proposed several changes to paragraph 202 to clarify how the evaluation of design and determination of implementation informs the</p>

	<p>auditor’s further audit procedures (see Agenda Item A). In addition, the Task Force is proposing the following additional paragraph.</p> <p><i>A202A. In addition, when identified controls are designed effectively and implemented, risk assessment procedures may generally influence the auditor’s determination of the nature or timing of substantive procedures to be performed (for example, the auditor may determine to perform inspection rather than external confirmation or to perform procedures at an interim date rather than at period end).</i></p>
<p>Questions for the Board</p>	<p>What are the ASB’s views about the additional application material to address comments regarding the assessment of control risk?</p> <p>In addition, what are the ASB’s views about the additional application material and other clarifications that were made to address comments related to how the evaluation of design and determination of implementation informs the auditor’s further audit procedures?</p>

H. Clarifying the Concept of Reasonable Possibility

<p>Issue</p>	<p>What guidance should be provided to clarify that the concept of “reasonable possibility” means more than remote?</p>
<p>Discussion</p>	<p>As described in the Issues Paper presented at the March 2021 ASB meeting, 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.</p> <p>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.</p> <p>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:</p>

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	<ul style="list-style-type: none"> • 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. <p>AU-C section 501, <i>Audit Evidence – Specific Considerations for Selected Items</i>, includes similar definitions.</p> <p>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).</p>
<p>Preliminary view</p>	<p>As described in the Issues Paper presented at the March 2021 ASB meeting, 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.</p> <p>The Task Force had presented several options for consideration by the Board, including:</p> <ul style="list-style-type: none"> • Option 1 – 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). • Option 2 – 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. • Option 3 – A reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is more than remote. <p>As previously indicated, the ASB debated these options and various views were expressed, particularly with respect to use of the term “remote.” After discussion, the ASB directed the Task Force to consider adding application material but reconsider the various options proposed based on ASB feedback.</p> <p>After discussion, the Task Force ultimately concluded that Option 3 is consistent with what is intended by ISA 315 (Revised 2019) as well as US GAAS, within AU-C section 265 and AU-C section 501.</p>
<p>Proposed changes</p>	<p>The Task Force proposes the following change to paragraph A11 (<i>boldface italics</i> denotes new language):</p> <p style="text-align: center;"><i>Relevant Assertions</i></p>

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	<p>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). <i>A reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is more than remote.</i> If an assertion does not have an identified risk of material misstatement, then it is not a relevant assertion.</p>
<p>Questions for the Board</p>	<p>Does the Board agree with the proposed changes to clarify the concept of “reasonable possibility” within the proposed SAS?</p>

I. Documenting a Combined Assessment of Inherent Risk and Control Risk

<p>Issue</p>	<p>Is the auditor required to document a “combined” assessment of inherent risk and control risk?</p>
<p>Discussion</p>	<p>During the outreach sessions, questions were raised with regard to documenting a combined assessment of inherent risk and control risk.</p> <p>Extant AU-C 200 and AU-C 315 permit either separate or combined assessments of inherent risk and control risk. The following approaches have been identified in practice:</p> <ul style="list-style-type: none"> • Separate inherent risk and control risk assessments • Separate inherent risk and control risk assessments with a combined assessment • Combined assessment alone. <p>Paragraph .A44 of extant AU-C 200 recognizes that “... 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.”</p> <p>SAS No. 143, <i>Auditing Accounting Estimates and Related Disclosures</i>, and the proposed SAS require separate inherent risk and control risk assessments. The proposed amendment to AU-C 200 now indicates “GAAS typically refer to the risks of material misstatement, rather than inherent risk and control risk</p>

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	<p>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 in accordance with AU-C section 330.”</p> <p>The following two requirements in the proposed SAS, in particular, raise the question as to whether a combined risk assessment is required to be documented:</p> <ul style="list-style-type: none"> • Paragraph .34 requires that, if the auditor does not plan to test the operating effectiveness of controls, the auditor’s assessment of control risk should be such that <i>the assessment of the risk of material misstatement</i> is the same as the assessment of inherent risk. • Paragraph .38 requires the auditor to include in the audit documentation, among other things, the identified and assessed risks of material misstatement at the financial statement level and at the assertion level, including significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made. <p>Extant AU-C section 315 currently requires the auditor to include in the audit documentation the identified and assessed risks of material misstatement at the financial statement level and at the assertion level. As previously indicated, the auditor may make separate or combined assessments of inherent risk and control risk.</p> <p>The intent of paragraph .34 is to essentially require a “maximum” control risk assessment if the auditor does not plan to test the operating effectiveness of controls, rather than to impose a combined assessment of inherent risk and control risk.</p>
<p>Preliminary views</p>	<p>The auditor may, but is not required to, document a combined assessment of inherent risk and control risk. The changes in the proposed SAS are intended to require separate inherent risk and control risk assessments, which also align with the requirement in paragraph .07 of AU-C section 330 to separately consider inherent risk and control risk in designing further audit procedures. The changes are not intended to also impose a combined inherent risk and control risk assessment. Accordingly, the Task Force proposes additional guidance to clarify this point; however, the Task Force discussed whether the additional guidance may indirectly expand upon the requirements for documenting the identified and assessed risks of material misstatement (that is, creating an implicit versus explicit requirement).</p>
<p>Proposed changes</p>	<p>The Task Force proposes the following new paragraph A264 (<i>boldface italics</i> denotes new language):</p>

	<p><i>A264. AU-C section 200 describes that GAAS typically refer to the risks of material misstatement, rather than inherent risk and control risk separately.^{FN} However, this proposed SAS 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 in accordance with AU-C section 330. Accordingly, the auditor may, but is not required to, document a combined assessment of inherent risk and control risk.</i></p> <p><i>FN Paragraph .A45 of AU-C section 200</i></p>
<p>Questions for the Board</p>	<p>Does the Board agree with the preliminary views and the proposed changes? Does the Board believe that the guidance creates an implicit requirement related to documenting the identified and assessed risks of material misstatement (in particular, separately documenting the auditor’s inherent and control risk assessments)?</p>

J. New “Explanatory Memorandum” or “Wrap” Document

<p>Issue</p>	<p>Should the ASB issue an “explanatory memorandum” or “wrap” document (similar to the one issued with Exposure Drafts) concurrent with the final SAS?</p>
<p>Discussion</p>	<p>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:</p> <ul style="list-style-type: none"> • 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... <p>During the outreach sessions, we noted that certain aspects were better understood when additional supplementary explanations were provided to the stakeholders.</p>

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<p>Preliminary views</p>	<p>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 is expected to include a revised audit guide, which may include flowcharts and other visualizations. In addition to the implementation guidance, the Task Force believes that an explanatory memorandum or “wrap” document could greatly enhance the understandability as well as implementation of the final SAS by providing additional transparency about the fundamental aspects of the proposed SAS. The IAASB historically has issued a Basis of Conclusions document alongside its auditing standards. The explanatory memorandum or wrap document would be more akin to a “summary” similar to the FASB’s accounting standards updates, rather than a “basis for conclusions” that would include a more extensive discussion about the ASB’s deliberations.</p> <p>The Task Force believes that AICPA staff could develop a proposed framework for such explanatory memorandum or wrap document. In addition, the AITF could be requested to discuss the process for issuing such a document.</p>
<p>Proposed changes</p>	<p>Issue an explanatory memorandum (or “wrap” document) together with the final SAS.</p>
<p>Questions for the Board</p>	<p>Does the Board agree with issuing an explanatory memorandum (or “wrap” document) alongside the issuance of the final SAS?</p> <p>If so, does the Board agree with requesting the AICPA staff to develop a proposed framework for an explanatory memorandum (or “wrap” document) and requesting the AITF to discuss the process related to issuance?</p>

Assessment of Control Risk

Request for Comment No. 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?

Summary of Results

Support	13	
Support with Comments	10	<ol style="list-style-type: none"> 1. Florida 2. NJ 3. Texas 4. RSM 5. TIC 6. KPMG 7. Eide Bailly 8. PwC 9. Firriolo 10. Illinois
Does not support	4	<ol style="list-style-type: none"> 1. Virginia 2. GAO 3. GT 4. MRA
Did not answer	5	

Excerpts from Comment Letters

1. The clarity of the requirement to assess control risk is outlined very clearly in the list of requirements, however additional clarity would be beneficial in other sections of the SAS. Specifically, as noted in paragraph 34 within the requirements section of the SAS, it is very clear how the auditor should assess control risk when test of controls will not be performed. The Committee noted that this clarity does not extend to the more detailed guidance later in the SAS. Specifically, in paragraphs A248 – A252, there is no mention of how the control risk should be assessed in the circumstance in which the auditor does not intend to test

controls. Furthermore, this clarity is, again, not noted in the proposed adjustments outlined in Appendix G. While the intention is clear in the overall review of this SAS, the codified guidance should be updated to reflect this clarity to ensure that it properly reflects the intent of the Board. (Florida)

2. The standard and application materials could be better organized and simplified and contain clearer definitions of key terminology and concepts to enhance the auditor’s understanding of the standard and implementation. (NJ)
3. The conclusions about control risk must be documented, even if the auditor plans the audit assuming no reliance on internal controls. There should be a direct correlation between the risk assessment and audit work, with consideration given to the size and complexity of the entity. (Texas)
4. On page 16 of the Exposure Draft, the ASB states its intention to clarify that “if the auditor does not contemplate testing the operating effectiveness of controls, or is not required to test controls, control risk is assessed at maximum (that is, the assessment of the risk of material misstatement is the same as the assessment of inherent risk). This means that control risk cannot be reduced based on the effective operation of controls unless the auditor intends to test them.” We do not believe the requirements in paragraph 34 clearly reflect the ASB’s intention. (RSM)
5. While paragraph 34 outlines the effect of not testing operating effectiveness of controls on the auditor’s control risk assessment, it is not clear that if we plan to test operating effectiveness, our control risk assessment is based on our understanding of the design and implementation of the controls and an expectation that the controls are operating effectively. Paragraph A248 discusses this concept; however, we believe it should be explicitly stated in the requirements. (KPMG)
6. In the definition of paragraph 12, inherent risk is to be assessed “before consideration of controls.” Paragraph 31b discusses the that the risk of material misstatement at the financial statement level affects the assessment of inherent risk at the assertion level. Paragraph A238 similarly connects the financial statement-level risks to inherent risk considerations. However, paragraph A217 states that the financial statement risk “is influenced” by the understanding of internal controls. Consequently, the guidance in paragraph A217 indirectly links certain control considerations to inherent risk through the financial statement-level assessment. We believe this is a conflict in the ED that should be clarified. (Eide Bailly)
7. We support the discussion in paragraph A249 of the proposed SAS that the auditor’s assessment of control risk may be performed in different ways, depending on preferred audit techniques or methodologies. Suggest making clarifications to paragraph A249. (PwC)
8. With all due respect – I did have to read the material a few times, but it eventually became clear. I believe D&I should be well defined and the text of the proposed SAS should be simplified. (Firriolo)

9. Overall, the Committee believes that the proposed standard is clear with respect to the need to assess control risk. However, the Committee does have a suggestion regarding the explanatory and other application guidance on how to assess control risk in situations where the auditor does not plan to test the operating effectiveness of controls. Currently, Paragraph 34 and the Explanatory Memorandum states that, “if the auditor does not contemplate testing the operating effectiveness of controls, or is not required to test controls, control risk is assessed at maximum (that is, the assessment of the risk of material misstatement is the same as the assessment of inherent risk)”. The Committee has a concern that the parenthetical statement could be misconstrued and result in an auditor erroneously assessing control risk at the same level as its assessment of inherent risk - versus meaning that control risk is automatically set at 100%. The Committee suggests that the parenthetical statement be removed to avoid confusion or, in lieu of that, add explanatory and other application material showing a mathematical application such as the following is suggested:
- Risk of material misstatement = inherent risk x control risk
 - Example with not testing operating effectiveness of internal controls
 - 75% (RMM) = 75% (inherent risk) x 100% (control risk)
 - Example with testing operating effectiveness of internal controls
 - 37.5% (RMM) = 75% (inherent risk) x 50% (control risk) (Illinois)
10. Four responders disagreed with the guidance.
- a. There is some confusion on why there is a need to identify and understand the client’s internal controls, if there will be no reliance on the effectiveness of controls, A252. A requirement to gain an understanding and identify controls that will then be ignored seems to be an inefficient way to run an audit. Also, a walkthrough of controls that provides no audit evidence that reduces overall risk seems to be an inefficient use of resources. (Virginia)
 - b. We suggest better clarifying the requirement to assess control risk when the auditor does not plan to test the operating effectiveness of controls. In our view, further clarification is needed to assist auditors in correctly and consistently applying this requirement. Paragraph 34 of the proposed SAS states, “If the auditor does not plan to test the operating effectiveness of controls, the auditor’s assessment of control risk should be such that the auditor’s assessment of the risks of material misstatement is the same as the assessment of inherent risk.” It is our view that this language is unclear. Such language may imply that the auditor is not required to assess control risk when the auditor does not plan to test the operating effectiveness of controls. A requirement that is presumptively mandatory should state what the auditor is to do versus not to do. (GAO)
 - c. Concerned that the requirements, as drafted, are overly limiting because they do not allow for situations where the entity has controls in place that are effectively design

and implemented. Effective design and implementation could be an input or consideration in designing the appropriate response. Control risk is an entity risk that exists independently of the audit. Operationally, control risk can be assessed by determining control reliance. We believe there should be a difference between an audit response where design and implementation are effective and where they are not. Suggest clarification of how the auditor's understanding of controls impacts the auditor's response to risks of material misstatement and the design of audit procedures that address those risks, as a control risk assessment of "maximum" is clearly evident only when applying audit sampling. (GT)

- d. What is confusing is the phrase "the auditor's assessment of control risk should be such that ..." In practice, many auditors take a formulaic approach to risk assessment, e.g., "moderate" IR and "high" CR = "high" RMM. When auditors read paragraph 34, I'm afraid that most of them will think through their formulas and try to figure out how to "plug" their CR assessment so that IR = RMM. This seems like an unproductive line of thought. (MRA)

Task Force Views

There was overall support from the responders. The Task Force will consider and respond to the specific comments. In particular, the Task Force will consider the effect on the auditor's responses when the auditor does not plan to test the operating effectiveness of controls (that is, how evaluating the design and determining the implementation of control activities can influence the design of the auditor's further audit procedures).

The Task Force acknowledges that the IAASB intended to address the influence of the auditor's evaluation of the design and determination of the implementation of controls in ISA 315, and the same application material was retained in the exposure draft, specifically in paragraphs A23, A138, A141, A167, A174, A179, A200, A201, A202, A252. The more relevant guidance from the exposure draft is provided below:

A138. The auditor is required to identify specific controls in the control activities component, and evaluate the design and determine whether the controls have been implemented, because it assists the auditor's understanding about management's approach to addressing certain risks; therefore, it provides a basis for the design and performance of further audit procedures responsive to these risks as required by AU-C section 330. The higher on the spectrum of inherent risk a risk is assessed, the more persuasive the audit evidence needs to be. Even when the auditor does not plan to test the operating effectiveness of identified controls, the auditor's understanding may still affect the design of the nature, timing, and extent of substantive procedures that are responsive to the related risks of material misstatement.

A202. When the auditor does not plan to test the operating effectiveness of identified controls, the auditor's evaluation of the design and determination of the implementation of certain controls may still assist in the design of the nature, timing, and extent of substantive procedures that are responsive to the related risks of material misstatement. Examples are as follows:

- The results of these risk assessment procedures may provide a basis for the auditor's consideration of possible deviations in a population when designing substantive procedures.
- Performance of these risk assessment procedures may lead the auditor to identify a fraud risk related to inadequate segregation of duties in the payroll function, and the auditor may decide to perform certain substantive procedures to address the risk of fictitious employees as a result.
- During the process of evaluating the design of certain controls related to sales, the auditor may become aware that the entity enters into bill-and-hold transactions with customers, and the auditor may design specific substantive procedures related to the agreements with the customers to test appropriateness of revenue recognition under the applicable financial reporting framework.

A252. Regardless of whether the auditor plans to test the operating effectiveness of controls for the purpose of assessing control risk, the auditor's understanding of the entity and its environment, the financial reporting framework, and the entity's internal control informs the auditor's design of further audit procedures. Examples follow:

- The auditor's understanding of internal control may indicate that controls are not designed or implemented appropriately, or the entity's control environment does not support the effective operation of control. In this case, there is no point in testing controls; the further audit procedures will consist solely of substantive procedures. If the auditor determines, pursuant to paragraph 33, that substantive procedures alone cannot provide sufficient appropriate audit evidence, the auditor may need to consider the effect on the auditor's report, as described in AU-C section 330.⁶² ⁶¹Paragraphs .A32–.A33 of AU-C section 330.
- The auditor's understanding of the entity's information system and communication will inform the auditor about the nature of documentation available for testing. For example, if the entity's records are all electronic, the auditor may design audit procedures differently than if the entity's records are in paper format.

It is important to note that the auditor's understanding of controls cannot positively influence the auditor's inherent risk assessment (that is, reduce inherent risk); inherent risk is assessed absent consideration of controls. Likewise, in accordance with the proposed SAS, the auditor's understanding of controls cannot influence the auditor's assessment of the risk of material misstatement (that is, the combined assessment of inherent risk and control risk), as design and implementation alone require the auditor to default to inherent risk (that is, the combined risk of material misstatement assessment with control risk set at maximum).

The "interplay" between inherent risk and control risk as well as the related impact on the auditor's further audit procedures can only be "clearly" evidenced in sampling theory (that is, through the inputs to a sampling calculator and the resulting extent of the items to be selected for testing). The Task Force notes that the Audit Sampling Guide, which is based on the audit risk

model, currently recognizes how the auditor's evaluation of design and determination of implementation may influence the design of further audit procedures. In particular, the current guide states the following:

When the auditor has performed only an assessment of design and implementation and assessed the design as effective and has obtained evidence that the controls have been implemented, the auditor might use a slightly lower confidence level for detailed substantive procedures (for example, 92 percent or 93 percent rather than a 95 percent confidence level if that was the level that the auditor would have otherwise planned for tests of details had the design or implementation of controls been assessed as ineffective).

The guide also states:

When the auditor has performed only an assessment of design and implementation of internal controls and assessed the design as effective and has obtained evidence that the controls have been implemented, the auditor might accept a slightly higher risk of incorrect acceptance (lower confidence level) for substantive tests of details than had the design or implementation of controls been assessed as ineffective.

These paragraphs recognize that the sufficiency and appropriateness of audit evidence that is necessary may differ when controls are effectively designed and implemented compared to situations in which controls are not implemented or are ineffective. While the guide is focused on the extent of testing (that is, when applying audit sampling), the same concepts would apply to the nature and timing of testing. All of the auditor's understanding obtained as a result of risk assessment procedures is taken into account in designing the nature, timing, and extent of further audit procedures.