



## 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 discuss the proposed SAS, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, which has been revised to take into consideration the issues identified in the comment letters received in response to the exposure draft and the feedback provided by the Auditing Standards Board (ASB or the Board) at the January, March, and May meetings. The revised draft of the proposed SAS is being discussed with the goal of voting to issue a final standard in August 2021.

#### **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

#### **Agenda Materials**

Agenda Item 2: Cover Memo

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*

Agenda item 2C: Draft of Executive Summary

Ms. Manasses will use Item 2A in leading the discussion.

## May ASB Meeting

The ASB continued to discuss several issues and changes at the March ASB meeting. The ASB's discussion was primarily focused on the requirements and application material of the proposed SAS related to the issues presented. The Task Force had not completed its review of the appendices of the proposed SAS and conforming amendments. Thus, those sections were not presented for discussion at the May ASB meeting.

The following provides a summarized version of the May ASB meeting highlights with a focus on the Board's recommendations or conclusions:

- A. **Spectrum of Inherent Risk**—The ASB agreed with the Task Force's recommendation to add a description of the spectrum of inherent risk within the definition of inherent risk factors but suggested adding a separate caption titled *spectrum of inherent risk* within the definition section with a reference to the definition of inherent risk factors in order to enhance its searchability.
- B. **Evaluation of Internal Control Components (Excluding Control Activities)**—The ASB agreed with the Task Force's recommendation to edit the requirements in paragraphs 21b, 22b, 24b, and 25c and to clarify the guidance that inquiry alone may be sufficient in obtaining an understanding of 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 components of internal control. The Task Force Was directed to determine whether guidance can be further enhanced by improving its organization.
- C. **The Entity's Risk Assessment Process and Interplay with AU-C section 240**—The Task Force suggested clarifying the requirement in paragraph 22 to specifically refer to understanding the entity's process for identifying the potential for fraud. This change is intended to align paragraph 22 of the proposed SAS with paragraph 17 of AU-C section 240. The ASB agreed with the Task Force's recommendation.
- D. **Evaluation of the Information System and Communication**—The ASB agreed with the the Task Force's recommendations to (a) edit paragraph 25 of the proposed SAS to include the reference to considering the nature and complexity of the entity, and (b) add application material that refers to Appendix C, which further describes the information system and communication component.
- E. **Separating the Requirements Related to Control Activities**— To enhance clarity and readability, the Task Force suggested restructuring paragraph 26 into separate paragraphs. Such restructuring is responsive to comments related to complexity and understandability of the proposed SAS. The ASB agreed with the Task Force's recommendation.
- F. **Controls over Journal Entries**—At its prior meeting, the ASB agreed that paragraph .26(a)(ii) (renumbered as 27b) is intended to cover the requirement in paragraph 32(a)(i) in AU-C section 240, which is incremental to ISA 240. The ASB directed the Task Force to the

to modify the requirement in the proposed SAS, rather than make the conforming amendments to AU-C section 240 proposed by the Task Force.

**G. Assessing Control Risk**—The ASB agreed to edit paragraph 34 such as follows to clarify the language in the requirement to make the requirement more understandable based on comments received from responders:

34. 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 assess control risk at maximum such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.

This is a difference in wording only, not a difference between the requirement in ISA 315 (Revised 2019) and the proposed SAS (that is, not ISA-plus, ISA-minus, or ISA-different).

The ASB also agreed with the additional guidance that was added to the proposed SAS that addresses how the auditor’s evaluation of design and determination of implementation of identified controls may impact the nature or timing of the auditor’s further audit procedures.

**H. Clarifying the Concept of Reasonable Possibility**—Based on the ASB’s instructions, the Task Force suggested adding application material that explains that a reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is more than remote. The ASB agreed with the Task Force’s recommendation.

**I. Documenting a Combined Assessment of Inherent Risk and Control Risk**—The Task Force’s view is that the auditor may, but is not required to, document a combined assessment of inherent risk and control risk. The ASB agreed with the Task Force’s recommendation to include such guidance in the proposed SAS.

**J. New “Explanatory Memorandum” or “Wrap” Document**—The ASB directed the Task Force to prepare an executive summary to be issued simultaneously with the final SAS. Such document, albeit non authoritative would be reviewed by the ASB before issuance, similar to the explanatory memorandum that accompanies a proposed standard.

### **Matters for the Attention of the ASB**

The following areas represent the most significant edits made by the Task Force to the proposed SAS since the draft was presented at the May 2021 ASB meeting and other matters that the Task Force is highlighting for the ASB.

<i>Internal Control Application Guidance</i>	As indicated above, at its May 2021 meeting, the ASB directed the Task Force to review the application material dealing with obtaining an understanding the components of internal control and determine whether any changes were necessary to enhance the organization and readability of that section of the proposed SAS. The Task Force
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	<p>reviewed that guidance and is suggesting some reorganization of that section of the proposed SAS (see paragraphs A102 – A110).</p>
<p><i>Appendices E and F</i></p>	<p>Appendix E, <i>Considerations for Understanding Information Technology</i>, and Appendix F, <i>Considerations for Understanding General IT Controls</i>, provide guidance that the auditor might consider in obtaining an understanding of the entity’s information technology (IT) and general IT controls, respectively. Included in those appendixes are tables that are intended to provide examples of typical characteristics of the IT environment based on specific types of IT applications (Appendix E) and examples of general IT controls that may address examples of risks arising from the use of IT (Appendix F). A responder (EY) commented that the information in those tables is not clear and is confusing. In reviewing EY’s comments, the Task Force agreed that the tables are confusing and too prescriptive for the proposed SAS and decided that a better location for these tables would be in the revised audit guide where more information could be provided to put the information of the table in better context.</p>
<p><i>COSO and Green Book Analysis</i></p>	<p>The Task Force analyzed the Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) 2013 <i>Internal Control—Integrated Framework</i> and the U.S. Government Accountability Office’s <i>Standards for Internal Control in the Federal Government</i> (the “Green Book”), by assessing whether the COSO and Green Book principles are covered in the proposed SAS (see detailed analysis in the Appendix to this Cover Memo). Based on this analysis, the Task Force made the following changes:</p> <ol style="list-style-type: none"> <li>1. Added “including the potential for fraud” to paragraph 22a I, which deals with the requirement of the auditor to obtain an understanding of the entity’s risk assessment process. This addition was previously discussed with the ASB at its May 2021 meeting and the ASB agreed with the change.</li> <li>2. Added application material in paragraph A126 related to the entity’s risk assessment process to deal with changes that could significantly impact of internal control.</li> </ol>
<p><i>Considerations Specific to Governmental Entities</i></p>	<p>The application material of the proposed SAS includes various paragraphs that are intended to provide guidance specific to audits of governmental entities. Responders to the Exposure Draft (such as</p>

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	<p>TIC and Eide Bailly) observed that those paragraphs could also provide guidance related to other regulated entities.</p> <p>The Task Force reviewed these paragraphs to assess whether the guidance is specific to audits of governmental entities. Based on this review, the Task Force concluded that the guidance in some of these paragraphs is broader and could be applicable to audits other than those of governmental entities and, therefore, modified and moved that guidance to the main application material (paragraphs A32, A51, A54, A82, and A225). In one instance, the Task Force concluded that the guidance is duplicative of the requirements and guidance in AU-C section 250 and, thus, suggests deleting this paragraph (see previous paragraph A246).</p>
<p><i>ESG Guidance Related to Climate Change</i></p>	<p>In October 2020, IFAC issued an audit staff alert on climate change. The ASB chair and the Chief Auditor discussed how to leverage this guidance in developing an AICPA publication. The AICPA will endeavor in developing a separate publication, but since climate change is pertinent to an entity’s business risks, an idea discussed was to acknowledge climate change as part of risk assessment in the proposed SAS. To that end, considering the guidance in the IFAC audit staff alert, a principles-based paragraph was included in the application material (see paragraph A74) and other guidance was added related to climate change risks (see paragraph 9 of Appendix C).</p>
<p><i>AU-C section 935, Compliance Audits</i></p>	<p>The Task Force considered whether additional conforming amendments to AU-C section 935 were necessary. However, the Task Force believes that changes to AU-C section 935 would be beyond making conforming amendments because a detailed assessment might be necessary to determine the applicability of various requirements in the proposed SAS to a compliance audit engagement. In consultation with the chair of the ASB, it was concluded to treat the applicability of this proposed SAS to a compliance audit as a separate project to be conducted following the issuance of this standard much like the ASB did in revising AU-C section 935 (and other AU-C sections) when AU-C section 700 was revised. This avoids delaying the issuance of this proposed SAS and allows for the necessary time to consult with other stakeholders, such as the AICPA’s State and Local Governments Expert Panel.</p>

The Task Force also reviewed the Audit Guide, *Assessing and Responding the Risk of Material Misstatement*, for the purpose of assessing whether the Audit Guide contains guidance that

would be useful in the proposed SAS. The Task Force concluded that no guidance exists in the Audit Guide that should be added to the proposed SAS.

**Questions for the Board**

What are the Board's comments on the proposed SAS, and what are the Board views on the following matters:

- a) Reorganization of internal control paragraphs dealing with obtaining an understanding of the components of internal control
- b) Deletion of the tables in Appendixes E and F
- c) Disposition of the COSO principles
- d) Modifications related to considerations specific to governmental entities
- e) Inclusion of ESG guidance in the Application Material and Appendix C, and
- f) Compliance Audits?

The following includes a comparative analysis between COSO, the Green Book, and the proposed SAS. It also includes the Task Force's proposed disposition.

COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
<b>Control Environment</b>			
The organization demonstrates a commitment to integrity and ethical values.	The oversight body and management should demonstrate a commitment to integrity and ethical values.	21a i. how management's oversight responsibilities are carried out, such as the entity's culture and management's commitment to integrity and ethical values;	No changes
The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.	The oversight body should oversee the entity's internal control system.	21a 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;	No changes
Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.	Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.	21a iii. the entity's assignment of authority and responsibility;	No changes
The organization demonstrates a commitment to attract, develop, and retain competent	Management should demonstrate a commitment to	21a iv. how the entity attracts, develops, and retains competent individuals;	No changes

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COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
individuals in alignment with objectives.	recruit, develop, and retain competent individuals.		
The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.	Management should evaluate performance and hold individuals accountable for their internal control responsibilities.	21a v. how the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control; and	No changes
<b>Risk Assessment</b>			
The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.	Management should define objectives clearly to enable the identification of risks and define risk tolerances.	A126. ...may consider...has done the following: <ul style="list-style-type: none"> <li>• Specified the entity’s objectives with sufficient precision and clarity to enable the identification and assessment of the risks relating to the objectives</li> </ul>	No changes; while not a requirement, this is appropriately addressed
The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.	Management should identify, analyze, and respond to risks related to achieving the defined objectives.	22a i. identifying business risks, including the potential for fraud, relevant to financial reporting objectives; 22a ii. assessing the significance of those risks, including the likelihood of their occurrence; and 22a iii addressing those risks	See disposition below



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<b>COSO</b>	<b>Green Book</b>	<b>Proposed SAS - Requirements</b>	<b>Proposed Task Force Disposition</b>
The organization considers the potential for fraud in assessing risks to the achievement of objectives.	Management should consider the potential for fraud when identifying, analyzing, and responding to risks.	See paragraph 22a i above	Added “including the potential for fraud” to the requirement
The organization identifies and assesses changes that could significantly impact the system of internal control.	Management should identify, analyze, and respond to significant changes that could impact the internal control system.	See paragraph A126	Added “assesses changes that could significantly impact the system of internal control” to the application guidance
<b>Information and Communication</b>			
The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.	Management should use quality information to achieve the entity’s objectives	Paragraph 25 addresses the understanding of the information system relevant to financial reporting. This understanding includes, among other things, the entity’s information-processing activities	No changes
The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.	Management should internally communicate the necessary quality information to achieve the entity’s objectives.	25b understanding how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control (Ref: par. A159–A160)	No changes

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COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
		<ul style="list-style-type: none"> <li>i. between people within the entity, including how financial reporting roles and responsibilities are communicated,</li> <li>ii. between management and those charged with governance,</li> </ul>	
The organization communicates with external parties regarding matters affecting the functioning of internal control.	Management should externally communicate the necessary quality information to achieve the entity's objectives.	25b iii. with external parties, such as those with regulatory authorities.	No changes
<b>Control Activities</b>			
The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.	Management should design control activities to achieve objectives and respond to risks.	Paragraphs 26-29 address the auditor's responsibilities related to understanding and evaluating controls within the control activities component in the context of a financial statement audit; there is no separate evaluation of this particular component	No changes
The organization selects and develops general control activities over technology to support the achievement of objectives.	Management should design the entity's information system and related control activities to achieve objectives and respond to risks.	See comment on paragraphs 26-29 above	No changes; specific requirements exist with respect to IT general controls

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COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
The organization deploys control activities through policies that establish what is expected and in procedures that put policies into action.	Management should implement control activities through policies.	See comment on paragraphs 26-29 above	No changes
<b>Monitoring Activities</b>			
The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.	Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.	24a i. ongoing and separate evaluations for monitoring the effectiveness of controls and the identification and remediation of control deficiencies identified	No changes
The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and those charged with governance, as appropriate.	Management should remediate identified internal control deficiencies on a timely basis.	See paragraph 24a i above	No changes