AICPA

Agenda Item 2C

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Executive Summary

Overview

The Auditing Standards Board has issued Statement on Auditing Standards (SAS) No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, to supersede SAS No. 122, as amended, section 315 of the same title, and to amend various AU-C sections in AICPA Professional Standards. SAS No. 145, for example, enhances the following:

- requirements and guidance related to the auditor's risk assessment, in particular, obtaining an understanding of the entity's system of internal control and assessing control risk; and
- guidance that addresses the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate.

SAS No. 145 also includes, among other things, the following:

- revised requirements to evaluate the design of certain controls within the control activities component, including general information technology controls, and determine whether such controls have been implemented
- new requirement to separately assess inherent risk and control risk
- new requirement to assess control risk at the maximum level such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk, if the auditor does not plan to test the operating effectiveness of controls
- a revised definition of significant risks;
- new guidance on scalability;
- new guidance on maintaining professional skepticism;
- a new "stand-back" requirement intended to drive an evaluation of the completeness of the auditor's identification of significant classes of transactions, account balances, and disclosures
- revised requirements relating to audit documentation; and
- a conforming amendment to perform substantive procedures for each relevant assertion of each *significant* class of transactions, account balance, and disclosure, regardless of the assessed level of control risk (rather than for all relevant assertions related to each *material* class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement, as previously required).

SAS No. 145 does not fundamentally change the key concepts underpinning audit risk. Rather, SAS No. 145 clarifies and enhances certain aspects of the identification and assessment of the risks of material misstatement to drive better risk assessments and, therefore, enhance audit quality.

The SAS becomes effective for audits of financial statements for periods ending on or after December 15, 2023.

Introduction

This executive summary provides an overview of Statement on Auditing Standards (SAS) No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (SAS No. 145). This document aims to highlight changes that are viewed to be of most interest (but is not inclusive of all changes).

Background

Deficiencies in the auditor's risk assessment procedures is a common issue identified by practice monitoring programs in the US and worldwide. In 2020 US peer reviews, AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,* was the leading source of matters for further consideration (MFCs), constituting 25% of MFCs.[1]

The Auditing Standards Board's (ASB) project to enhance the auditing standards relating to the auditor's risk assessment through the issuance of SAS No. 145 is intended to enable auditors to appropriately address the following:

a. understanding the entity's system of internal control, in particular, relating to the auditor's work effort to obtain the necessary understanding;

b. modernizing the standard in relation to IT considerations, including addressing risks arising from an entity's use of IT; and

c. determining risks of material misstatement, including significant risks.

Convergence

SAS No. 145 was developed using as the base International Standard on Auditing (ISA) 315, *Identifying and Assessing the Risks of Material Misstatement* (Revised 2019). ISA 315 (Revised 2019) is effective for audits of financial statements for periods beginning on or after December 15, 2021.

Each SAS differs from its corresponding ISA only where the ASB believes compelling reasons exist for the differences. AU-C Appendix B, *Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards*, of AICPA *Professional Standards* includes an analysis prepared by the AICPA Audit and Attest Standards staff that highlights substantive differences between the SASs and ISAs, and the rationales therefore.

Link to SAS No. 143 Auditing Accounting Estimates and Related Disclosures

Some of the new concepts in SAS No. 145 have already been introduced in SAS No. 143, *Auditing Accounting Estimates and Related Disclosures,* including inherent risk factors, the spectrum of inherent risk, and the separate assessments of inherent risk and control risk. These

[1] AICPA Center for Plain English Accounting, *Improving Risk Assessments in Private Company Audits*, July 21, 2021

concepts are applicable to all types of classes of transactions, account balances, and disclosures, not just those involving accounting estimates. Because of the close interaction between SAS No. 145 and SAS No. 143, their effective dates have been aligned such that both standards will be effective for audits of financial statements for periods ending on or after December 15, 2023.

Fundamental Aspects of SAS No. 145

SAS No. 145 builds on the foundational concepts relating to an audit of financial statements in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, (such as audit risk, identifying risks at the financial statement and assertion levels, and the definitions of *inherent risk* and *control risk*).

SAS No. 145 is principles based and audit methodology neutral. The degree to which SAS No. 145 might impact an audit methodology may vary based on the particular audit approach and related audit methods, tools, or techniques.

Scalability of SAS No. 145 ***[Enhanced and New Guidance]***

Complexity of an entity's activities and its environment, including internal control, is the primary driver of scalability in the application of SAS No. 145. SAS No. 145 has removed the "Considerations Specific to Smaller Entities" sections previously in the application material but has incorporated most of that content elsewhere in the standard, as appropriate, together with further revisions to promote scalability. SAS No. 145 recognizes that although the size of an entity may be an indicator of its complexity, some smaller entities may be complex, and some larger entities may be less complex.

In addition, SAS No. 145 recognizes that some aspects of the entity's system of internal control may be less formalized but still functioning. When the entity's systems and processes lack formality, the auditor may still be able to perform risk assessment procedures through a combination of inquiries and other risk assessment procedures (for example, corroborating inquiries about the entity's processes through observation or inspection of documents).

Maintaining Professional Skepticism ***[Enhanced and New Guidance]***

SAS No. 145 contains several key provisions that are designed to enhance and emphasize the auditor's professional skepticism, including the following:

- Clarifying that an appropriate understanding of the entity and its environment, and the applicable financial reporting framework, provides a foundation for being able to maintain professional skepticism throughout the audit

- Highlighting the benefits of maintaining professional skepticism during the required engagement team discussion

- Highlighting that contradictory evidence may be obtained as part of the auditor's risk assessment procedures.

Modernization for an Evolving Business Environment ***[New Guidance]***

SAS No. 145 includes additional guidance that addresses significant changes in, and the evolution and increasingly complex nature of, the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate. It also recognizes the ability to use automated tools and techniques (including audit data analytics) when performing risk assessment procedures.

Obtaining an Understanding of the Entity and Its Environment, and the Applicable Financial Reporting Framework (paragraphs .19-.20) *[New Requirements]*

SAS No. 145 elevates the importance of understanding the applicable financial reporting framework by restructuring the previous requirements. In addition, SAS No. 145 includes:

- A new explicit requirement to understand the use of IT in the entity's structure, ownership and governance, and business model. SAS No. 145 defines the IT environment, which includes IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies.

- A new requirement to obtain an understanding of how inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework (the concept of inherent risk factors is described further below).

Obtaining an Understanding of the Entity's System of Internal Control (paragraphs .21-.31) *[New Requirements and Enhanced Guidance]*

Understanding certain aspects of the entity's system of internal control is integral to the auditor's identification and assessment of the risks of material misstatement, regardless of the auditor's planned controls reliance strategy. SAS No. 145 clarifies that the overall understanding of the entity's system of internal control is achieved through understanding, and evaluating certain aspects of, each of the following components of the system of internal control (and performing the related requirements to obtain such an understanding):

1. the control environment,

2. the entity's risk assessment process,

3. the entity's process to monitor the system of internal control,

4. the information system and communication, and

5. control activities.

Each component comprises a collection of controls, which may be direct or indirect.[2] While differing requirements exist with respect to each component, SAS No. 145 clarifies the auditor's responsibilities, including the requirements to evaluate the design of certain controls within the control activities component and determine whether such controls have been implemented.

The nature, timing, and extent of risk assessment procedures that the auditor performs to obtain the required understanding are: 1) matters of the auditor's professional judgment, and 2) based on the auditor's determination of the procedures that will provide sufficient appropriate audit evidence to serve as a basis for the identification and assessment of the risks of material misstatement.

Terms Used to Describe Aspects of the Entity's System of Internal Control

SAS No. 145 applies certain revised terms consistently. These changes, made throughout GAAS, include the following:

- The term *internal control* has been changed to *system of internal control*, and the definition has been updated to reflect that it comprises five interrelated components.
- The use of the term *controls* has been clarified by including the following definition in the standard: (see paragraph 12)

> "Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context
>
> i. policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.
> ii. procedures are actions to implement policies."

Understanding the Components of the Entity's System of Internal Control

When identifying controls that address the risks of material misstatement, SAS No. 145 clarifies the requirement to evaluate the design and determine the implementation of certain controls within the control activities component. These controls include:

- Controls that address a risk that is determined to be a significant risk;

[2] *Direct controls* are controls that are precise enough to address risks of material misstatement at the assertion level. *Indirect controls* are controls that support direct controls. Although indirect controls are not sufficiently precise to prevent, or detect and correct, misstatements at the assertion level, they are foundational and may have an indirect effect on the likelihood that a misstatement will be prevented or detected on a timely basis.

- Controls over journal entries and other adjustments as required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*;

- Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which includes controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence;

- Other controls that, based on the auditor's professional judgment, the auditor considers appropriate to enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures.

As described further below, SAS No. 145 also requires the auditor to identify general IT controls that address the risks arising from the use of IT and to evaluate their design and determine their implementation.

The controls for which the auditor is required to evaluate design and determine implementation are referred to as identified controls in SAS No. 145. Such controls might also be referred to as relevant controls or key controls in some audit methodologies.

The following table provides a high-level summary of the auditor's responsibilities and work effort related to understanding, and evaluating certain aspects of, the components of the entity's system of internal control in accordance with SAS No. 145.

<table>
<tr><th colspan="5">Components of the Entity's System of Internal Control</th></tr>
<tr><th colspan="3">Primarily Indirect Controls</th><th>Primarily More Direct Controls but may be Indirect Controls</th><th>Primarily Direct Controls</th></tr>
<tr><th>Control Environment</th><th>Entity's Risk Assessment Process</th><th>Entity's Process to Monitor the System of Internal Control</th><th>Information System and Communication</th><th>Control Activities</th></tr>
<tr><td colspan="3">SAS No. 145 includes requirements to understand, and evaluate certain aspects of, the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control components. The auditor's required understanding includes the ongoing tasks and activities, or processes, geared to the achievement of the entity's financial reporting objectives.

Audit evidence for the auditor's understanding and evaluation may be obtained through a combination of inquiries and other risk assessment procedures (for example, corroborating inquiries about the entity's processes through observation or inspection of documents). The auditor exercises professional judgment to determine the nature and extent of the procedures to be performed to the meet the requirements of SAS No. 145.

SAS No. 145 does not require the auditor to evaluate the design or determine the implementation of individual controls within these components. However, the auditor may, based on the auditor's professional judgment, identify controls within these components that address risks of material misstatement at the assertion level for which the auditor evaluates design and determines implementation.</td><td>SAS No. 145 includes a requirement to understand, and evaluate certain aspects of, the information system and communication component. For this component, the auditor's understanding includes, among other things, the flows of transactions and other aspects of the entity's information-processing activities for significant classes of transactions, account balances, and disclosures as well as the entity's communication of significant matters.

SAS No. 145 does not require the auditor to evaluate the design or determine the implementation of individual controls within the information and communication component. It is important to note that the auditor's identification and evaluation of controls in the control activities component is focused on information-processing controls, also known as transaction controls.</td><td>SAS No. 145 includes specific requirements to understand certain controls within the control activities component that address risks of material misstatement at the assertion level.

For the identified controls that address risks of material misstatement at the assertion level, the auditor is required to evaluate the design and determine whether the controls have been implemented. The identified controls include:
Controls that address a risk that is determined to be a significant risk
Controls over journal entries and other adjustments as required by AU-C section 240
Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence
Other controls that, based on the auditor's professional judgment, the auditor considers are appropriate to enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures.
Identified controls also include those general IT controls that address risks arising from the use of IT, as described in the following section.</td></tr>
</table>

Risks Arising from the Use of IT and General IT Controls

SAS No. 145 now defines the terms "risks arising from the use of IT" and "general information technology (IT) controls." SAS No. 145 requires the auditor to identify general IT controls that address the risks arising from the use of IT and to evaluate their design and determine their implementation.

General IT controls need not be identified for every IT process. General IT controls are identified based on the risks arising from the use of IT. To identify the risks arising from the use of IT, the auditor identifies the IT applications and other aspects of the entity's IT environment that are subject to such risks. Such IT applications and other aspects are identified based on the identified controls that address the risks of material misstatement at the assertion level, as described in the table above under control activities. Appendix E of SAS No. 145 includes guidance that may be relevant in identifying IT applications and other aspects of the IT environment that may be subject to risks arising from the use of IT.

Other Matters Relevant to Understanding the Entity's System of Internal Control

Consistent with AU-C section 265, *Communicating Internal Control Related Matters in an Audit,* SAS No. 145 includes an explicit requirement that, based on the auditor's understanding, and evaluation of certain aspects of, the components of the entity's system of internal control as required by SAS No. 145, the auditor should determine whether one or more control deficiencies have been identified. The auditor may determine that a significant deficiency or material weakness exists that impacts the auditor's risk assessments and related response.

Identifying and Assessing the Risks of Material Misstatement (paragraphs .32-.38) *[New Requirements and Enhanced Guidance]*

The auditor's risk identification and assessment process is iterative and dynamic. In obtaining the understanding required by SAS No. 145, initial expectations of risks may be developed, which may be further refined as the auditor progresses through the risk identification and assessment process.

To assist auditors in understanding the requirements related to the identification and assessment of the risks of material misstatement, SAS No. 145 clarifies various requirements and also introduces new concepts and definitions, as described in the following table.

Inherent risk factors and spectrum of inherent risk (new)	*Inherent risk factors* are characteristics of events or conditions that affect the 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 quantitative or qualitative and include complexity, subjectivity, change, uncertainty, and susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk. Depending on the degree to which the inherent risk factors affect the susceptibility of an assertion to misstatement, the level of inherent risk varies on a scale that is

	referred to as the *spectrum of inherent risk.* The spectrum of inherent risk provides a frame of reference in determining the significance of the combination of the likelihood and magnitude of a misstatement. Inherent risk factors are intended to assist the auditor in focusing on those aspects of events or conditions that affect an assertion's susceptibility to misstatement, which in turn, facilitates a more focused identification of risks of material misstatement at the assertion level. Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement assists the auditor in assessing inherent risk, which also informs the auditor's design of further audit procedures in accordance with AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. It is the intersection of the magnitude and likelihood of the material misstatement on the spectrum of inherent risk that will determine whether the assessed inherent risk is higher or lower on the spectrum of inherent risk.
Relevant assertions (revised)	The definition of a relevant assertion was revised to clarify that an assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement, taking into account the likelihood and magnitude of a misstatement. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). SAS No. 145 also clarifies that there is a reasonable possibility when the likelihood of a material misstatement occurring is more than remote. This guidance is consistent with that provided in other AU-C sections (for example, AU-C section 265). The determination of whether an assertion is a relevant assertion continues to be made before consideration of any related controls (that is, the determination is based on inherent risk).
Significant class of transactions, account balance, or disclosure (new)	While the term "significant class of transactions, account balance, or disclosure" is used within GAAS, particularly within AU-C section 940, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements,* it was not defined. A class of transactions, account balance, or disclosure is considered significant when it has an identified risk of material misstatement at the assertion level (that is, there is one or more relevant assertions as defined in the previous section of this table). The determination of whether a class of transactions, account balance, or disclosure is significant is made before consideration of any related controls (that is, the determination is based on inherent

	risk). The definition and guidance in SAS No. 145 are consistent with how the term was interpreted by various auditors when applying AU-C section 940. The introduction of the concept of a significant class of transactions, account balance, or disclosure is intended to clarify the scope of the auditor's understanding of the entity's information-processing activities as well as the auditor's responsibilities related to the identification and assessment of, and responses to, risks of material misstatement.

As a reminder, AU-C section 240 continues to address the auditor's responsibilities relating to fraud in an audit of financial statements and expands on how SAS No. 145 and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, are to be applied regarding risks of material misstatement due to fraud.

Assessing Inherent Risk and Control Risk Separately

For risks of material misstatement at the assertion level, SAS No. 145 now requires separate assessments of inherent risk and control risk, which is consistent with SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.[3] SAS No. 145, however, does not prescribe a specific method for making such risk assessments nor require a combined assessment of inherent risk and control risk. The auditor's separate assessments of inherent risk and control risk may be performed in different ways, depending on preferred audit techniques or methodologies, and may be expressed in different ways.

Assessing Control Risk at the Maximum Level

If the auditor does not plan to test the operating effectiveness of controls, SAS No. 145 now requires the auditor to assess control risk at the maximum level such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk. In other words, tests of the operating effectiveness of controls are required to support a control risk assessment below the maximum level.

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 controls may still assist in the design of substantive procedures. When identified controls are designed effectively and implemented, risk assessment procedures may influence the auditor's determination of the nature and 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).

[3] Statement on Auditing Standards (SAS) No. 143, *Auditing Accounting Estimates and Related Disclosures*, was approved by the Auditing Standards Board in May 2020 and, when issued, will have an effective date of audits of financial statement for periods ending or after December 15, 2023.

Significant Risks

To promote a more consistent approach to determining significant risks, SAS No. 145 revised the definition of *significant risks* to focus not on the response (that is, whether a risk requires special audit consideration), as was the case with the previous definition, but on the inherent risk assessment. Accordingly, the definition in SAS No. 145 focuses on those risks for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur. Significant risks also include those that are to be treated as a significant risk in accordance with the requirements of other AU-C sections (that is, AU-C section 240 and AU-C section 550, *Related Parties*).

SAS No. 145 no longer requires the auditor to determine whether a financial statement level risk is a significant risk. However, identified risks of material misstatement at the financial statement level may affect the auditor's assessment of significant risks at the assertion level.

SAS No. 145 acknowledges that the determination of whether a risk is a significant risk requires the application of professional judgment. AU-C section 330 continues to include special audit considerations in the form of specific requirements related to significant risks because of the nature of the risk and the likelihood and potential magnitude of misstatement related to the risk.

Classes of Transactions, Account Balances, and Disclosures That Are Not Significant but Are Material (paragraph .40) *[New and Revised Requirements]*

SAS No. 145 includes a new "stand-back" requirement intended to drive an evaluation of the completeness of the identification of significant classes of transactions, account balances, and disclosures by the auditor. For material classes of transactions, account balances, or disclosures that have not been determined to be significant classes of transactions, account balances, or disclosures (that is, there are no relevant assertions identified), SAS No. 145 requires the auditor to evaluate whether the auditor's determination remains appropriate. Materiality is in the context of the financial statements. Accordingly, classes of transactions, account balances, or disclosures are material if there is a substantial likelihood that omitting, misstating, or obscuring information about them would influence the judgment made by a reasonable user based on the financial statements.

The stand-back differs from the requirement in paragraph .18 of AU-C section 330, which was previously revised to align with the definitions in SAS No. 145 and with PCAOB standard AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*. Paragraph .18 of AU-C section 330 was revised to now require the auditor to perform substantive procedures for each relevant assertion of each *significant* class of transactions, account balance, and disclosure, regardless of the assessed level of control risk (rather than for all relevant assertions related to each *material* class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement, as previously required). [*emphasis added*]

Audit Documentation (paragraph .42) *[New Requirements]*

SAS No. 145 also revises the related audit documentation requirements to include the following new requirements:

- Documentation of the evaluation of the design of identified controls, and determination of whether such controls have been implemented

- The rationale for significant judgments made regarding the identified and assessed risks of material misstatement

The form, content, and extent of audit documentation that is sufficient to enable an experienced auditor having no previous experience with the audit to understand the nature, timing, and extent of the risk assessment procedures and the results of those procedures, including the conclusions reached and the rationale for the significant professional judgments made, depend on various factors, including the need to document a conclusion or the basis for a conclusion otherwise not readily determinable from the documentation of the work performed or audit evidence obtained.