Ms. Sherry Hazel  
Audit & Attest Standards  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036-8775


Dear Ms. Hazel:

Ernst & Young LLP (Ernst & Young) is pleased to submit this comment letter to the Auditing Standards Board (ASB) in response to the ASB’s request for comment regarding the above-referenced proposed Statement on Auditing Standards (proposed SAS).

We support the issuance of the proposed SAS. We agree with the ASB’s proposal to move the content of AT section 501, *An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With An Audit Of Its Financial Statements* (AT 501), from the attestation standards into generally accepted auditing standards (GAAS). Further, we support the development of an attestation standard addressing examinations of internal control that aren't integrated with audits of financial statements.

Attached is our response to each of the ASB’s questions for respondents as well as additional comments for your consideration. We would be pleased to discuss our comments with members of the ASB or its staff.

Sincerely,

Ernst & Young LLP
Responses to guide for respondents

**Question 1:** Are respondents aware of any unintended consequences that would result from moving the content of extant AT section 501 from the attestation standards into GAAS?

No, we are not aware of any unintended consequences.

**Question 2:** Do respondents agree with the approach the ASB has taken in proposing a separate standalone SAS instead of addressing an integrated audit in each relevant existing AU-C section?

Yes, we agree with the approach the ASB has taken.

**Question 3:** Do the respondents agree with the approach the ASB has adopted related to the 2013 COSO framework?

Yes, we agree with the approach the ASB has adopted related to the 2013 COSO framework. Specifically, we agree with the underlying presumption in the proposed SAS that management will use the 2013 COSO framework (including the requirement to evaluate the five components of internal control by assessing the principles in the 2013 COSO framework). We also support the flexibility of the proposal to allow auditors to adapt and apply the standard when management uses another internal control framework, such as the U.S. Government Accountability Office's Standards for Internal Control in the Federal Government (the Green Book).

**Question 4:** Does the defined term significant class of transactions, account balance, or disclosure have the effect of better aligning terminology with minimal impact on practice?

Yes, we believe the defined term significant class of transactions, account balance, or disclosure has the effect of better aligning terminology with minimal impact on practice. Specifically, we agree with:

- Changing the term significant account or disclosure used in AT Section 501 to significant class of transactions, account balance, or disclosure to align with terminology used in extant GAAS and to clarify that the risk factors the auditor is required to evaluate in the identification of significant classes of transactions, account balances, and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements.

- Amending AU-C section 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, to include the definition of significant class of transactions, account balance, or disclosure.
Comments for consideration

► The proposed effective date is for integrated audits for periods ending on or after 15 December 2016. We believe the ASB should consider accelerating the effective date to 15 December 2015. The proposed SAS does not represent a new standard, but rather moves the content from extant AT section 501 into GAAS. Further, changes made to extant AT section 501 in the proposed SAS are primarily designed to adhere as closely as possible to PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements (PCAOB AS 5), which has been effective since 2007. Accordingly, it is our view that the profession requires a minimal transition period to implement the proposed SAS. While we believe the ASB should consider accelerating the effective date, we also encourage the ASB to coordinate the effective date of the proposed standard with any necessary revisions to requirements impacted by the proposed standard (e.g., the Federal Deposit Insurance Corporation Improvement Act).

► The proposed standard includes reference to “control deviations” in paragraphs 45 and A73. We suggest the term “control deviation” be defined in the “Definitions” section as “an occurrence of a control being tested that did not operate as designed or was not performed for a transaction(s). All control deviations should be evaluated to determine if a deficiency in internal control exists.” While this term is not defined in PCAOB AS 5, it has been our experience that confusion exists among the terms “control deviation” and “control deficiency” and the corresponding required audit response.

► We recommend that Paragraph 26 of the proposed SAS be revised to clarify the ASB’s intent of the requirement. The paragraph currently states:

The auditor is required to obtain an understanding of the control environment. In addition, the auditor should evaluate the control environment by determining whether the following principles exist in the design, implementation, and operation of ICFR to achieve the entity’s financial reporting objectives.

We believe that the beginning of the second sentence – that is, the words “In addition, the auditor should...” – and similar language in paragraphs 27-30 could lead to confusion about whether the procedures that follow are required. We suggest the following revision to paragraph 26 (and corresponding revisions to paragraphs 27-30):

The auditor is required to obtain an understanding of the control environment. In addition, the auditor is required to evaluate the control environment by determining whether the following principles exist in the design, implementation, and operation of ICFR to achieve the entity’s financial reporting objectives.

► We suggest the following revisions to paragraph 29 to clarify the ASB’s intent:

The auditor is required to obtain an understanding of the entity’s control activities relevant to the financial statement audit. In addition, the auditor is required to evaluate the entity’s control activities relevant to the audit of ICFR by determining whether the following principles exist in the design, implementation, and operation of ICFR to achieve the entity’s financial reporting objectives:

The entity selects and develops control activities that contribute to the mitigation of risks to the achievement of financial reporting objectives to acceptable levels.
The entity selects and develops general control activities over technology to support the achievement of financial reporting objectives.

The entity deploys control activities through policies that establish what is expected and procedures that put policies into action to support the achievement of financial reporting objectives.

We recommend moving paragraphs 56 and 57 after paragraph 50 under “Evaluating the Identified Deficiencies in ICFR” and revising former paragraph 56 as follows:

In an audit of ICFR, in addition to evaluating the findings from the auditor’s testing of controls for the ICFR audit, the auditor also should evaluate the effect of the findings of the substantive procedures performed in the audit of financial statements on the effectiveness of ICFR. This evaluation should include, at a minimum

- the risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- findings with respect to noncompliance with laws and regulations.
- findings with respect to related party transactions and complex or unusual transactions.
- indications of management bias in making accounting estimates and in selecting accounting principles.
- the extent of misstatements detected by substantive procedures.

As part of evaluating evidence obtained from all sources, the auditor should review reports issued during the year by the internal audit function (or similar functions) that address controls related to ICFR and evaluate deficiencies identified in those reports.

We believe the procedures described in these paragraphs are performed in connection with the evaluation of an identified deficiency and whether that deficiency is a material weakness or a significant deficiency rather than when forming an opinion.

We recommend removing “recalculation” from the proposed list of procedures to be performed when obtaining an understanding of likely sources of misstatement, evaluating design effectiveness of controls and testing operating effectiveness of controls to avoid potential unintended consequences such as an auditor performing recalculation as a substantive procedure to infer that a control is designed and operating effectively. PCAOB AS 5 does not include recalculation as a procedure to be performed in these circumstances. When applying PCAOB AS 5, recalculation is performed only in connection with the reperformance of a control owner’s procedures. Otherwise, the execution of this procedure could be viewed as a substantive procedure performed to infer that a control is designed and operating effectively. As stated in

1 Proposed SAS, paragraphs A53, A60, A68, A70 and A72
2 PCAOB AS 5, paragraphs 37 and 45
PCAOB AS 5 and the proposed SAS: “To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures.”\(^3\) This interpretation of PCAOB AS 5 has been reinforced through audit deficiencies noted by the PCAOB.

We suggest the following revision to paragraph A53 to clarify that a walkthrough of a single transaction may not be sufficient to obtain an understanding of the likely sources of misstatement for a significant class of transactions with multiple transaction types (e.g., direct deposit versus payment by check in a payroll process).

Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 36. A walkthrough involves following a transaction from origination through the entity’s processes, including information systems, until it is reflected in the entity’s financial records, using the same documents and IT that entity personnel use. If a significant class of transactions contains more than one material transaction type, a walkthrough of multiple transactions may need to be performed to understand the likely sources of misstatement for each material transaction type. Walkthrough procedures include a combination of inquiry, observation, inspection of relevant documentation, recalculation and control reperformance.

We suggest the following revision to paragraph A69 to align with PCAOB AS 5 and to clarify that the absence of misstatements detected by substantive procedures should be a consideration when making risk assessments, and such consideration may or may not change the auditor’s risk assessment in determining the testing necessary to conclude on the operating effectiveness of a control. Further, we believe this revision reinforces the requirement that evidence about whether a selected control is effective must be obtained through directly testing that control.

The operating effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures may affect informs the auditor’s risk assessments in determining the testing necessary to conclude on the operating effectiveness of a control.

We suggest paragraph A74 be revised as follows:

The objective of the tests of controls in an audit of ICFR is to obtain evidence about the effectiveness of controls to support the auditor’s opinion on the entity’s ICFR. The auditor’s opinion relates to the effectiveness of the entity’s ICFR as of a point in time and as a whole. Accordingly, an audit of ICFR entails testing the design and operating effectiveness of controls ordinarily not tested when expressing an opinion only on the financial statements as well as other controls that may not be tested when expressing an opinion only on the financial statements.

While it is accurate that an audit of ICFR entails testing a greater number of controls than might be tested when expressing an opinion only on the financial statements, it has been our experience that many of the controls tested in an audit of ICFR are the same controls that would be tested for a financial statement audit. We believe the proposed revision provides this clarification.

\(^3\) PCAOB AS 5, paragraph B9 and the Proposed SAS, paragraphs 44 and A69
We suggest the following revision to paragraph A87 to clarify the intent of the application guidance (i.e., a misstatement would be associated with an account balance or disclosure, not a class of transactions) and to align with the proposed changes to paragraph A84 of the proposed standard and paragraph A8 of AU-C Section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in ICFR will result in a misstatement of a class of transaction, an account balance or a disclosure.

We suggest the control deficiency aggregation considerations addressed in paragraph A90 be expanded to include evaluating the combination of deficiencies identified at an individual component. As multiple deficiencies identified at a single component of such an entity may indicate a significant deficiency or a material weakness, we recommend the following revisions:

A deficiency in ICFR on its own may not be sufficiently important to constitute a material weakness. However, a combination of deficiencies affecting the same significant class of transactions, account balance, or disclosure, relevant assertion, *component of an entity*, or component of ICFR may increase the risks of misstatement to such an extent to give rise to a material weakness. A combination of deficiencies that affect the same significant class of transactions, account balance, or disclosure, relevant assertion, *component of an entity*, or component of ICFR also may collectively result in a significant deficiency.

We suggest the following revisions to paragraph A129 to clarify the intent of the application guidance.

The auditor may conclude it is appropriate to limit the assertion by excluding certain entities when, for example, law or regulation permits management to do so, or when management has insufficient time to assess the controls at the as of date for a recently acquired business or does not have sufficient access to a consolidated variable interest entity. However, in the case of an acquired entity, it would not be appropriate for management to limit its assertion if the period of such limitation extends beyond one year from the date of acquisition, nor would it be appropriate for management’s assertion to be limited for more than one annual management report on ICFR. Law or regulation may also specifically address situations in which it is appropriate for management to limit its assertion by excluding certain entities and also may require specific disclosures in these cases. If, in the auditor’s judgment, it is appropriate for management to limit its assertion by excluding certain entities, the auditor may limit the audit of ICFR in the same manner, and the auditor’s opinion would not be affected by a scope limitation.

We suggest references to “material class of transactions, account balance, and disclosure” in paragraphs 18 and A45 of AU-C Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, and paragraph 3 of AU-C Section 505, *External Confirmations*, be revised to “significant class of transactions, account balance, and disclosure” to align with the terminology used in the proposed SAS, as well as other Statements on Auditing Standards.