Dear Auditing Standards Board Members,

Thank you for the opportunity to comment on your exposure draft *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements*. I read the ED with great interest as the topic of risk assessment and controls has been a big part of my professional life. I feel certain that revisions proposed in this exposure draft will help to clarify issues that auditors have struggled with. Many auditors have struggled to understand the “how and why” of risk assessment, including basic concepts such as “what is a control.” And so, I commend the Board for taking action to revise AU-C 315.

Like most commentors, however, I believe there are still opportunities for improvement. And I believe the greatest area for improvement and clarity is in the need for revisions to paragraphs 21 – 25. My fundamental concern is with the term “evaluating whether” and the requirements set forth in 21b, 22b, 24c, and 25c. Stated simply, my perception from reading this ED is that the ASB believes an auditor should perform an evaluation based merely on his or her understanding of controls without also evaluating whether such controls (at least those relevant to the audit) have been designed appropriately and have been implemented.

If my read and perception of the proposed ED is correct, I would question, given the current concerns around fraud and going concern, why the ASB wants to be seen potentially dumbing down the auditing standard with respect to understanding of internal control and especially the control environment? If my read and perception is incorrect and the ASB does not intend to eliminate or change existing auditor responsibilities, then I believe the ASB needs to revisit these requirement and application paragraphs to make its expectations clear.

As someone who very much appreciates the desire of the ASB to converge GAAS with the ISAs, I also believe, and have stated publicly on many occasions, that we never intended to blindly follow the ISA if we believe that we can create greater clarity or if we believe that we can improve the quality of an audit standard.

It may be helpful to understand that the IAASB undertook these changes in response to the IFAC SMP community. Specifically, the IFAC SMP committee was hearing from their members that auditors: 1) didn’t understand why they needed to gain an understanding of controls in these areas, 2) what “controls” there were in these four areas, especially for smaller entities, and 3) assuming they did understand what a control is and they identified a control relevant to the audit, they didn’t understand how to test a control for design and implementation (D&I).

As a member of IAASB when this project began, I tried to convince the task force and the IAASB that this approach could potentially “dumb down” this section and may have unintended consequences in that auditors could easily come to wrong conclusions about controls in these areas (especially the control environment), and as a result, auditors might not properly assess the risks of material misstatement (RMM).
Rather than dumbing down the standard, I believed that the standard (or guidance) should explain why it is important to understand what controls are or are not present and when a control exists that is relevant to the audit, how an auditor could perform procedures to evaluate the control’s design and determine if the control has been implemented. It was as if the concepts were too hard to understand by smaller firms and so the IAASB just eliminated the concepts.

I would point out that our SMP members are in a different position from IFAC’s SMP group because the AICPA has an authoritative risk assessment audit guide that addresses each of these internal control areas from an SMP perspective and we have a number of risk assessment audit tools and other guidance. My personal view is that smaller firm methodologies have also done a good job of creating quality guidance that helps SMP auditors in their understanding of controls and with evaluating D&I.

Therefore, I would strongly encourage the ASB to make sure that it agrees as to the problem it is trying to fix? Does the ASB believe that our SMP auditors are having the same issues as expressed by the IFAC SMP committee? If so, will these changes fix those issues without decreasing the quality of audits? If SMP auditors in the US do not have the same issues, why are you making the change? TIC would be a good proxy for many smaller firm auditors and so I would encourage the ASB to have that conversation.

My second recommendation is for the ASB to think through the unintended consequences from making these proposed changes. Does the ASB believe that an auditor’s responsibility, in terms of understanding and evaluating these four areas of internal control would be same as it is today? As mentioned previously, I believe the proposed words will “dumb down” auditor behavior and could potentially result in an inappropriate assessment of RMM.

Allow me to use a simple example where an auditor of a small entity inquires of the owner about a Code of Conduct. The owner replies that yes, they have a Code of Conduct, and delivers a two-page document to the auditor. In addition to reading the document, the auditor also inquires of the owner about the other elements described in 21a. The auditor dutifully documents his or her understanding and concludes (result of the evaluation) that “all is good.” This auditor designs further auditing procedures on the premise that all is good with the control environment (and the other three areas where D&I testing are not required). Unfortunately, for this auditor, that Code and those policies and procedures were never implemented, were never shared with the organization’s employees and in fact, the owner has very little regard for doing the “right thing.”

In my view, this is a real-life example of where an auditor could inappropriately design further auditing procedures based on an inadequate evaluation because the controls have not been implemented. As mentioned earlier, as I read 21b, I am left with the belief that the auditor has no responsibility to determine whether the Code or the other policies and procedures have been implemented, nor does the auditor seem to have an explicit responsibility to evaluate whether the policies (controls) would achieve the control objectives as set forth in COSO (or any comparable IC framework). I say an explicit responsibility because I do understand that some would argue
that there is an implicit requirement to evaluate suitability of design in order to evaluate whether

As a former COSO board member who issued the 2013 COSO framework, we spent a tremendous amount of time dealing with control environment element and the five principles that need to be present in order for the control environment to be effective. As COSO points out so clearly, it is critical that each of the five components and relevant principles are present and functioning (which in audit speak means that there are controls designed and implemented to achieve the object). Why would GAAS not require auditors to make those same present and functioning evaluations?

As I am sure you are aware, the ASB commented on the IAASB’s ISA 315 exposure draft in October 2018. In 2018, as today, I do not (nor did the ASB at that time) believe that an evaluation should be made simply based on an understanding of controls that may or may not have been implemented. Is it in the public’s interest and the interest of quality audits to ask an auditor to draw conclusions about whether:

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

without requiring the auditor to explicitly evaluate the design of the controls against IC criteria and without performing any procedures to determine whether the control has been implemented?

Given the current professional emphasis on fraud and going concern (which I applaud), I am hopeful that this board will reexamine its proposed requirements to make clear the importance of an appropriate understanding and evaluation of controls in each internal control element in order to make an informed and proper assessment of RMM.

While I haven’t provided specific wording changes, I am most happy to provide those at a later date should the ASB decide to revisit these concepts. But I would first start with extant and ask what is broken?

My best wishes,

Charles E. Landes