November 25, 2020

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

Re: Exposure Draft: Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement

VIA Email: CommentLetters@aicpa-cima.com

Dear Ms. Hazel:

Eide Bailly LLP is pleased to respond to the Auditing Standards Board (ASB) Exposure Draft (ED) document, Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement and is respectfully providing feedback on the ASB’s ED. We appreciate the ASB’s interest in updating and enhancing risk assessment.

The ED specifically asks for responses to the following questions:

1. Are the requirements and application material of the proposed SAS sufficiently scalable, that is, the proposed SAS capable of being applied to the audits of entities with a wide range of sizes, complexities and circumstances?

Response: Generally, we believe the proposed standard, particularly the application guidance, acknowledges scalability and provides some guidance. However, while much of the application guidance acknowledges the informality of controls and that evidence in less complex entities “may not be available in documentary form (paragraph A112)” it does not provide sufficient help to an auditor in determining at what point the lack of documented evidence would result in an inability to accomplish the objective. Paragraph A125 provides a good example of alternative documents that could provide corroborating evidence when it states, “e-mails and other correspondence between management and other personnel”. When such corroborating evidence cannot be produced by the organization, how does this impact the risk assessment? The standard is clear that inquiry alone is not sufficient, and that inquiry must be paired with observation procedures. Consequently, how would corroboration from multiple personnel without documented evidence be considered in the risk assessment process, particularly if the corroboration also consisted of inquiry only? We suggest the standard provide additional guidance and illustrations on how an engagement team would evaluate risk and related responses when corroborating documentary evidence does not exist.
2. Do the proposals made relating to the auditor’s understanding of the entity’s system of internal control assist with understanding the nature and extent of the work effort required and the relationship of the work effort to the identification assessment of the risk of material misstatement? Specifically:

   a. Have the requirements related to the auditor’s understanding of each component of the entity’s system of internal control been appropriately enhanced and clarified? Is it clear why the understanding is obtained and how this informs the risk identification and assessment process?

   b. Have the requirements related to the auditor’s identification of controls that address the risks of material misstatement been appropriately enhanced and clarified? Is it clear how controls that addressed the risks of material misstatement are identified, particularly for audits of smaller and less complex entities?

   c. Given that COSO’s 2013 Internal Control-Integrated Framework (COSO framework) is often used by entities subject to the AICPA’s generally accepted auditing standards, is the terminology in paragraphs 21-27 and related application material of the proposed SAS clear and capable of consistent interpretation for audits of entities that use the COSO framework?

   Response: We appreciate the ASB’s efforts to expand and clarify the requirements related to the understanding of each component of the entity’s systems of internal control and how it has clarified the risk identification and process.

   For question 2a, we believe the requirements related to the auditor’s identification of controls that address the risks of material misstatement have also been appropriately enhanced and clarified. We also believe the reasons why obtaining such level of understanding is also clear.

   For question 2b, we believe the identification of how controls address the risk of material misstatement are generally sufficient. However, see our response in question #1 for feedback on elements that could provide better guidance for smaller and less complex entities and our response to question #8 regarding the identification of which controls should be evaluated.

   For question 2c, we believe that the terminology is paragraphs 21-27 and related application materials are clear and capable of being consistently applied.

3. Are the enhanced requirements and application material related to the auditor’s understanding of the IT environment, the identification of the risks arising from the entity’s use of IT, and the identification of general IT controls clear to support the auditor’s consideration of the effects of the entity’s use of IT on the identification and assessment of the risks of material misstatement?

   Response: Yes, we believe the expectations of gaining an understanding of the IT environment is clear in the proposed standard.
4. Do you support the introduction in the proposed SAS of the new concepts and related definitions of significant classes of transactions, account balances, and disclosures, and their relevant assertions? Is there sufficient guidance to explain how they are determined (that is, an assertion is relevant when there is a reasonable possibility of occurrence of a misstatement that is material with respect to that assertion), and how they assist the auditor in identifying where risks of material misstatement exist?

Response: We believe the guidance in the proposal is clear regarding the definitions of significant classes of transactions, account balances, and disclosures. However, we believe that the definition and approach to relevant assertions will be a change in practice and philosophy for many firms. Many auditors start with identifying significant risks and then identify relevant assertions for less risky areas. The proposal suggests that an engagement team would start with identifying relevant assertions for all audit areas and then determine which relevant assertions are also significant risks. We believe clarity and illustrations should be added to the application guidance and/or an appendix to illustrate the flow of the risk assessment process. For instance, the illustration in the first bullet of A242 provides an example of when a risk would not be considered a significant risk. This illustration could be enhanced if it started with the identification of relevant assertions and the evaluation of why such assertions were not deemed to be a significant risk but clarify that sufficient appropriate audit procedures are still required to address the relevant assertions. Also, we suggest adding an illustration where relevant assertions result in a significant risk, including information about how the identification and evaluation of risk should be performed and the determination of sufficient, appropriate audit procedures documented.

Also, the definition of a relevant assertion within paragraph 12 states that an assertion is deemed relevant when “it has an identified risk of material misstatement,” and then it clarifies that this is an assessment based on inherent risk. We believe it is unclear whether it is expected that the inherent risk would have higher risk on the spectrum if it’s deemed to be relevant, and if so, that should be specified.

The definition of significant class of transactions, account balances, and disclosures is that one or more relevant assertions are present. An assertion is relevant “when it has an identified risk of material misstatement.” In the case of account balances, is it expected that if the balance is material (or could potentially be material such as an understated liability), that the account balance would always have a risk of material misstatement, and accordingly, would have relevant assertions? It is common in practice for account balances, such as prepaids, to be considered to have lower inherent risk, even if the balance is material. It is unclear in such a case whether prepaids would have relevant assertions, and accordingly, the impact on risk assessment is also unclear. Similarly, we believe there is uncertainty about whether an assertion is relevant when classes of transactions have material volume or disclosures are material but are assessed as having lower inherent risk. We recommend providing clarity in the standard as well as providing examples, such as the prepaid example, in the application guidance so that auditors will be able to understand the requirements and expected results of risk assessment.

5. Do you support the introduction of the spectrum of inherent risk into the proposed SAS?
Response: We support the concept of a spectrum of inherent risk. It is common for firms to use a spectrum of inherent risk today in their methodologies, although the number of points between higher and lower risk are limited.

6. Do you support the separate assessment of inherent and control risk in relation to all risks of material misstatement at the assertion level?

Response: Yes, we believe the assessment of inherent risk and control risk should be separate evaluations.

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?

Response: We agree that it’s important to understand the control environment regardless of whether controls will be tested for operating effectiveness. The proposed standard is clear that an engagement team must gain an understanding of the internal control system including observing key controls (i.e. perform walkthroughs) as inquiry alone is insufficient.

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.

In addition, the wording of paragraph 34 is difficult to follow. It could be worded as follows, “When an auditor does not plan to test the operating effectiveness of controls, then the risk of material misstatement would be the same as the assessment of inherent risk.”

8. What are your views regarding the clarity of the requirement in paragraph 26d of the proposed SAS to evaluate design and determine implementation of certain control activities (including, specifically, the requirement related to controls over journal entries?)

Response: Paragraph 26d provides appropriate clarity that areas identified in 26a and 26c should include procedures in addition to inquiry to verify whether control activities are implemented. However, we believe the full scope of what controls should include an observation procedure is uncertain. Paragraph 26a, items i-iii names significant risks, journal entries, and testing of controls. However, item iv of 26a is vague, and the application guidance in A181 provides some additional considerations, but the scope remains unclear. We believe this may result in less observation procedures in practice. Is the expectation that observation procedures should be performed on key controls over relevant assertions? If so, these should be clarified in the standard and the implementation guidance.

Also, while we think the content of 26d is clear in the expectation of evaluating the design and performing procedures in addition to inquiry, the flow is difficult to follow. We believe it would be easier to follow if 26d was a lead-in paragraph of 26 preceding items a-c.
9. Do you support the revised definition, and related material, on the determination of significant risks? What are your views on the matters previously presented relating to how significant risks are determined based on the spectrum of inherent risk?

Response: See our responses to questions #4 and #5. We believe the definition of significant risks could be confusing for auditors when determining the difference between relevant assertions and significant risks.

10. What are your views about the proposed stand-back requirement in paragraph 36 of the proposed SAS and the conforming amendments proposed to paragraph .18 of AU-C section 330?

Response: We believe that practitioners will struggle with the concept of a stand-back provision apart from the other risk assessment procedures. If risk assessment procedures are completed appropriately, what additional identification would be accomplished in the stand-back provision? It appears that the provision is intended to address items missed while performing other risk assessment procedures thereby indicating that other procedures were not completed correctly or sufficiently. Also, it is unclear how the observations from the stand-back provision would be documented. Would it be common, if risk assessment is completed appropriately that the audit documentation would indicate that nothing was noted? If a risk not previously identified was discovered, would it be separately documented, or would the other risk assessment areas be updated?

11. What are your views with respect to the clarity and appropriateness of the documentation requirements?

Response: Generally, we believe that documentation expectations are clear for the identification of risk factors at the assertion level for both controls and inherent risk. However, the proposed standard could be clearer on the documentation expectations to support the final conclusions reached on inherent risk at the assertion level. To elaborate, upon identifying and documenting the risk factors for a given relevant assertion, an auditor must then apply their judgement to such factors in determining where the risk falls on the spectrum. This is implied in paragraph 31 but should more clearly state that upon “assessing the likelihood and magnitude of misstatement”, the auditor should document their judgement to support their determination of specifying where the risk falls on the spectrum.

Also, see our response to question #10 which also has documentation considerations for the stand-back provision.

In addition to answering the questions above, we had the following additional observations and comments.

Throughout the application guidance there are sections that provide considerations specific to governmental entities. In many cases, the considerations are not unique to governments. For example, paragraph A28 discusses obtaining information from other auditors that are involved in “performance or other audits related to the entity.” Other auditors could be involved in any number of industries. Also, paragraph A30 discusses considerations regarding compliance requirements with applicable laws and regulation. Many non-governmental industries such as utilities, insurance, and financial institutions operate in regulated industries that might have similar considerations. Overall, we believe the
considerations are valid and should be retained but be broadened to other industries. Also, paragraph A52 makes a broad statement that doesn’t provide any specific or unique application considerations. We recommend examples be provided in this paragraph to illustrate what types of application considerations the paragraph is trying to convey.

Paragraph 16 and the related application guidance discusses when an “auditor intends to use” information obtained “from audit procedures performed in previous audits.” Paragraph 16 and the application guidance focus on procedures that should be performed to ensure that prior information is relevant and reliable. For example, paragraph A45 indicates that annual walk-throughs would be a means of making such determinations. It is unclear what procedures from previous audits could be relied upon that would not need to be repeated in the current year. If the purpose of these paragraphs is to provide an opportunity for an auditor to reduce current year procedures by relying on the information obtained from previous audit procedures, it would be helpful if the application guidance provided examples of when such reliance would be appropriate.

The following other edit observations:

- Should paragraph 38b include a reference to paragraph 25?
- Paragraph A183 references 26(b)(ii) which doesn’t exist. Should it be referenced to 26(c)(ii)?
- Paragraph A5 states: “Controls may be direct or indirect (see paragraphs A107 and A136).” Is the reference to A107 accurate, or should reference paragraph A108?
- Paragraph A94 discusses the use of audit evidence obtained by the auditor in performing other risk assessment procedures and references paragraph A105. Paragraph A105 references Appendix E which provides further guidance on understanding the use of IT in the components of the system of internal control. Should the reference be to A107?
- At the end of paragraph A140 it references itself “(see paragraph A140).”

We thank you for your consideration, and for your efforts on this proposal. You may reach me at 208.383.4753 for further clarification of our responses.

Sincerely,

Scot Phillips, CPA
Partner in Charge of the National Assurance Office
Eide Bailly LLP

cc: Brian Bluhm, Chief Quality Officer