COMMENT LETTER ON THE PROPOSED STATEMENT ON AUDITING STANDARDS – UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT. ALONG WITH THE PROPOSED CONFORMING AND CONSEQUENTIAL AMENDMENTS TO OTHER SECTIONS AND STANDARDS.

November 25, 2020

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The Advanced Auditing Class has reviewed the above-referenced Exposure Draft and offers the following comments for consideration to the American Institute of Certified Public Accountants Auditing Standards Board. Our comments can be classified into two main categories: Responses to Request for Comments and Comments Regarding Wording and Formatting to the Application Material Section.

**RESPONSES TO REQUESTS FOR COMMENTS**

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

Yes.

1. The proposed SAS states that the requirements to all entities regardless of whether their nature and circumstances are less complex or more complex.

2. The proposed SAS acknowledges the difficulty of identifying material misstatements, thus adding further requirements and guidance in AU-C section 240 in relation to risk assessment procedures. (A15)

3. The proposed SAS also stresses the importance of professional skepticism, which helps decision making in different scenarios. (A16)

**How:**

In order to stress the complexity over size of the entity in assessing the risks of material misstatements, the proposed SAS applies the requirements of risk assessment to all entities regardless of whether their nature and circumstances are less or more complex. Below list two examples of how the proposed SAS tries to establish a more comprehensive set of requirements for risk assessment for all kinds of entities.

a. Dual level of risk assessments, financial statement level and assertion level

b. Understand the entity and environment and establish the initial expectations of risks and then apply adjustments and modifications.

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 and assessment of the risks of material misstatement? Specifically: A98-A107 – P59

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?
Yes.
The auditor’s understanding of each component of the entity’s system of internal control provides a preliminary understanding of how the entity identifies risk of material misstatement relevant to financial reporting. The understanding of the internal control will affect the auditor's identification of risks of material misstatement at the assertion level and inherent risk.

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?

Yes.
The requirements of auditor’s identification of controls that address the risks of material misstatement have been enhanced from the stress of the importance of understanding each control component to the details of evaluating each. (starting at A111) The proposed SAS also takes into account the entities with various sizes and complexity and lays out the solutions to deal with different scenarios. (A112) For example, the audit evidence about elements of the control environment is less complex entities may not be available in documentary form, but a culture that emphasizes integrity might be developed, thus the actions of management are of particular importance to the auditor’s understanding of the control environment.

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?

Yes.
The proposed SAS further stresses the importance of understanding and evaluation of each of the five components of COSO, which will provide auditors a preliminary understanding of how the entity identifies business risks (A107). Besides, the proposed SAS divides them into two categories, direct and indirect. Communication and control activities are more direct in lecturing assertion-level risks (A101); while indirect controls are mostly used for financial-level misstatement (A108).

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?

Yes, the proposed SAS clearly reflects the importance that the auditor understands the aspects of an entity’s IT system, in particular how the integrity of information relevant to the preparation of the financial statements is maintained.
We agree with the proposed SAS addressing the entity’s use of IT are in the requirements for the information systems and communication components for identifying certain controls that address the risks of material misstatement.

We support the addition of appendix E “Considerations for Understanding Information Technology (Ref: par. 12, 25a, 26b-c, A105 and A182); and concur with the ASB that is not necessary for the auditor to identify risks arising from the entity’s use of IT, unless they relate to IT applications that are determined to be relevant for the auditor’s purpose.

- The auditor is required to understand the related IT environment in order to gain a high-level understanding of the nature and complexity of the environment and its supporting process. Imposing the proposed change will help the auditor determine which IT applications and other aspects of the IT environment are subject to risks arising from the use of IT. The addition of appendix “E” provides further clarification to matters that the auditor may consider in understanding the entity’s use of IT in its system of internal control.

The SAS for the purposes of GAAS, (see paragraph 12. Definitions), reflects the use of the following definitions to add clarity to the auditor in their assessment of IT’s use and risk management:

- General information technology (IT) controls.
- Information-processing controls.
- Inherent risk factors.
- Relevant assertions.
- Risks arising from the use of IT.

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, that 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?

Yes, we support the introduction in the proposed SAS of new concepts and related definitions (see paragraph 12. Definitions): A class of transactions, account balance, or disclosure for which there is one or more relevant assertions. This definition will provide further guidance to the auditor with respect to Inherent Risk Factors, and the benefit of clarifying the scope of the auditor’s understanding of the information system, and for the auditor’s identification and assessment of, and responses to, assessed risks of material misstatement, including the related requirements in the recently revised AU-C section 540 that address these topics in the context of auditing accounting estimates.

We also believe that there is sufficient guidance for auditors to determine that an assertion is relevant and the likelihood that the auditor will identify risks of material misstatement. The revisions to AU-C 315 will aid the auditor identify those assertions in which risks of material misstatement exist (that is, are reasonably possible) and, therefore, need to be assessed so further audit procedures may be designed and performed. The focus is on how certain aspects of the
identification and assessment of the risks of material misstatement can be clarified and improved in order to drive better risk assessments and, therefore, enhance audit quality.

5. Do you support the introduction of the spectrum of inherent risk into the proposed SAS?

Yes, we support the introduction of the “spectrum of inherent risk”, as introduced in paragraph 5 of the proposed SAS as it relates to the degree to which inherent risk varies. We believe it will facilitate greater consistency in the auditor’s identification and assessment of risks of material misstatement. It will provide a frame of reference for the auditor’s consideration of the likelihood and magnitude of possible misstatements and the influence of the inherent risk factors.

However, we suggest that a clear definition of the degree of variation within the SAS suggested “Spectrum” should be established in the proposed change. As referenced in paragraph A13 “Significant Risk” identified as risk of material misstatement, we need further guidance as to the acceptable degree of lower and upper end of the “Spectrum” should define a clear measurable scope that would be necessary to fall either at the “lower” and/or “higher” end of the “Spectrum”. We suggest a table weighing the comparison of the lower and higher risk of occurring, compared to the magnitude, to help the auditor’s judgment on whether it is a significant risk, as follows:

<table>
<thead>
<tr>
<th>Likelihood of occurrence</th>
<th>Low</th>
<th>Medium</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>low risk</td>
<td>low risk</td>
<td>risk</td>
</tr>
<tr>
<td>Medium</td>
<td>low risk</td>
<td>Significant risk</td>
<td>Significant risk</td>
</tr>
<tr>
<td>High</td>
<td>risk</td>
<td>significant risk</td>
<td>Significant risk</td>
</tr>
</tbody>
</table>
We acknowledge that this range is not a substitute for an auditor’s judgment based upon the unique circumstances of the audit engagement. However, we believe that reiterating these guidelines within the definition of “Spectrum” in the proposed SAS would add clarity and coherence to the definition of “spectrum of inherent risk.” To promote a more consistent approach to determining significant risks, the ASB revised the definition to focus not on the response but on those risks for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk.

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

Yes, we support the separate assessments of inherent and control risk in relation to all risks of material misstatement at the assertion level. The ASB agreed that this should be required, and it would appear in SAS No. 143 Auditing Accounting Estimates and Related Disclosures. So, this proposed SAS basically extends the requirements for separate assessments of inherent and control risk to all risks of material and misstatement at the assertion level. Since firms are going to have different approaches the process will be processed differently by auditors too (initial audit engagement or a recurring engagement). To further break it down auditors will have to be proficient in understanding internal control since they’ll have to decide what type of controls that address the risks of material misstatement based on the determination of significant risks.

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?

Testing the operating effectiveness of controls is essential since it is the foundation for auditor’s assessment of control risk. The ASB has made it clear that if the auditor does not contemplate testing the operating effectiveness of controls, or is not required to test controls, control risk is assessed at maximum (that is, the assessment of the risk of material misstatement is the same as the assessment of inherent risk). This means that control risk cannot be reduced based on the effective operation of controls unless the auditor intends to test them.

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)?

Clarity of the requirements in paragraph 26d of the proposed SAS to evaluate design and determine implementation of certain control activities such as related to controls over journal entries is extremely crucial. This means that control activities related to journal entries is extremely important since incorrect journal entries can end up producing improper work, which will affect companies or individuals’ future tax work. Without the clarity of the requirements in paragraph 26d, that would lead to fraud due to internal control. A194 explains how it is crucial it is for identifying controls by auditors in order to figure out if the control is capable of effectively preventing, or detecting and correcting, material misstatements. A194 in simple words explains
how auditors must be able to identify controls effectively and simply since those controls will help them to prevent or detect material misstatements. Also, A202 is the process of evaluating the design of certain controls related to sales, the auditor may become aware that the entity enters into bill-and-hold transactions with customers, and the auditor may design specific substantive procedures related to the agreements with the customers to test appropriateness of revenue recognition under the applicable financial reporting framework.

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?

We believe that the board’s decision to define both inherent and control risk was the right thing to do. This will clear most of the confusion that is created when trying to differentiate both, especially for younger auditors in the profession. The addition of including control risk when evaluating risk improves the audit in a way that makes the assertiveness of material misstatements due to these risks more manageable. This in all makes the quality of the audit more robust as more things are taken into consideration when it comes to identifying material misstatements in the financials. However, we strongly urge that a clear definition of the degree of variation within the SAS suggested “Spectrum” should be established in the proposed change. As suggested earlier, we need further guidance as to the acceptable degree of lower and upper end of the “Spectrum” should define a clear measurable scope to determine the “spectrum” on inherent risk.

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?

We welcome the proposed stand-back requirement in paragraph 36 of the proposed SAS. As user’s choices are swayed easily by the omittance of information, it is important to provide all available information that is material instead of leaving it to professional judgement. We also welcome the conforming amendments proposed to paragraph 18 of AU-C section 330. The conforming amendments proposed to paragraph .18 of AU-C section 330 are reflecting the changes addressed in the proposed SAS which are designing and performing substantive procedures for all assertions related to significant transactions instead of material transactions.

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

We believe that the documentation requirements are extremely clear as they detail a checklist that an auditor must complete as completing an audit. As suggested, detailing the auditor’s rationale on how they exercised professional skepticism is beneficial to the users. By providing the basis for the assessments on how inherent and control risk was acquired, the auditor would be able to support their professional judgement.
COMMENTS REGARDING WORDING AND FORMATTING TO THE APPLICATION MATERIAL SECTION

Removal of some words to better list material:

A6. The integrity of information may include the completeness, accuracy, and validity of transactions and other information. Although this proposed SAS does not prescribe the use of a particular internal control framework, the auditors may find the following guidance regarding the concepts encompassed by the term validity, from COSO's 2013 Internal Control—Integrated Framework (COSO framework), helpful: “Recorded transactions represent economic events that actually occurred and were executed according to prescribed procedures. Validity is generally achieved through control activities that include the authorization of transactions as specified by an organization’s established policies and procedures (that is, approval by a person having the authority to do so).”

Grammatical additions and fixes to add more clarity to the paragraph:

A7. Risks to the integrity of information arise from the susceptibility to the ineffective implementation of the entity’s information policies, which are policies that define the information flows, records, and reporting processes in the entity’s information system of an entity. Information-processing controls are procedures that support effective implementation of the entity’s information policies. Information-processing controls may be automated (that is, embedded in IT applications) or manual (for example, input or output controls) and may rely on other controls, including other information-processing controls or general IT controls.

Minor grammatical changes to the sentence:

A10. Other inherent risk factors that affect the susceptibility to misstatements of an assertion about a class of transactions, account balance, or disclosure may include one or both of the following

Changes to certain wordings and minor grammatical changes:

A16. Professional skepticism is necessary for the critical assessment of audit evidence gathered when performing the risk assessment procedures and assists the auditors in remaining alert to audit evidence that is not biased towards corroborating the existence of risks or that may be contradictory. Professional skepticism is an attitude that is applied by the auditors when making professional judgments that then provides the basis for the auditors’s actions. The auditors apply professional judgment in determining when they the auditor has have the audit evidence that provides an appropriate basis for risk assessment.

Minor wording changes for better flow of the paragraph:

A19. Designing and performing risk assessment procedures to obtain audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditors are not required to perform an exhaustive search to identify all possible sources of audit evidence. In addition to the information from other sources, sources of information for risk assessment procedures may include the following:
• Interactions with management, those charged with governance, and other key entity personnel, such as internal auditors
• Certain external parties such as regulators, whether obtained directly or indirectly
• Publicly available information about the entity, for example, entity-issued press releases, materials for analysts or investor group meetings, analysts’ reports, or information about trading activity

Grammatical fixes for simpler wording:

A21. Some entities, including less complex entities, and particularly owner-managed entities, may not have established structured processes and systems (for example, a risk assessment process or a process to monitor the system of internal control), or may have established processes or systems with limited documentation or a lack of consistency in how they are implemented or undertaking. When such systems and processes lack formality, the auditor may still be able to perform risk assessment procedures through observation and inquiry. Other entities, typically more complex entities, are expected to have more formalized and documented policies and procedures. The auditor may use such documentation in performing risk assessment procedures.

The removal of certain phrases to make it more manageable for the reader, and reduce the chances of the reader to misinterpret certain sentences:

A23. AU-C section 500 explains the types of audit procedures that may be performed in obtaining audit evidence from risk assessment procedures and further audit procedures. The nature, timing, and extent of the audit procedures may be affected by the fact that some of the accounting data and other evidence may be available only in electronic form or only at certain points in time. The auditor may perform substantive procedures or tests of controls, in accordance with AU-C section 330, concurrently with risk assessment procedures, such as when it is efficient to do so. Audit evidence obtained that supports the identification and assessment of risks of material misstatement may also support the detection of misstatements at the assertion level or the evaluation of the operating effectiveness of controls.

Simpler wording to fix the flow of the paragraph for the reader:

A24. Although the auditor is required to perform all the risk assessment procedures described in paragraph 14 in the course of obtaining the required understanding of the entity and its environment, the applicable financial reporting framework, and the entity’s system of internal control (see paragraphs 19–26), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed when the information to be obtained may be helpful in identifying risks of material misstatement. Examples of such procedures may include making inquiries of the entity’s external legal counsel, or of valuation specialists that the entity has used.

Removing unnecessary wording to simply convey the message better:

A28. When making inquiries of those who may have information that is likely to assist in identifying risks of material misstatement, auditors of governmental entities may obtain information from additional sources such as from the auditors that are involved in performance or other audits related to the entity.
The removal and restructuring of certain sentences to make it easier to read and understand for the reader:

A33. Analytical procedures performed as risk assessment procedures may be as follows:

- Include both financial and nonfinancial information, for example, the relationship between sales and square footage of selling space or volume of goods sold (nonfinancial).
- Use data aggregated at a high level. Accordingly, the results of those analytical procedures may provide a broad initial indication about the likelihood and potential magnitude of a material misstatement. For example, in the audit of many entities, including those with less complex business models, and processes, and a less complex information system, the auditor may perform a comparison of information, such as the change in interim or monthly account balances from balances in prior periods, to obtain an indication of potentially higher risk areas.

Grammatical fixes for better sentence structure:

A36. Observation and inspection may support, corroborate, or contradict inquiries of management and others, and may also provide information about the entity and its environment.

Grammatical changes, as well as restructuring of sentences to more efficiently convey the message:

A37. When policies or procedures are not documented, or the entity has less formalized controls, the auditor may still be able to obtain some audit evidence to support the identification and assessment of the risks of material misstatement through observation or inspection of the performance of the control. Examples are as follows:

Removal of words to better convey the message, addition of a period also removal of unnecessary parenthesis:

A39. Automated tools or techniques may also be used to observe or inspect, for example, through the use of remote observation tools such as a drone.

Editing of the fourth bullet point to better explain the sentence:

A44. The auditor’s previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about the following matters:

- Past misstatements and whether they were corrected on a timely basis
- The nature of the entity and its environment, and the entity’s system of internal control (including control deficiencies)
- Significant changes that the entity or its operations may have undergone since the prior financial period
- Those particular types of transactions, and other events, or account balances and/or related disclosures (and related disclosures) in which the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity.
Sentence restructuring for better reading and convey the message:

A48. Professional skepticism is necessary for the critical assessment of audit evidence. A robust and open engagement team discussion, including for recurring audits, may lead to improved identification and assessment of the risks of material misstatement, also applicable for recurring audits. Another outcome from the discussion may be that the auditor identifies specific areas of the audit for which exercising professional skepticism may be particularly important and may lead to the involvement of more experienced members of the engagement team who are appropriately skilled to be involved in the performance of audit procedures related to those areas.

Removing certain sentences that repeat the same message, further making the paragraph less confusing. Along with the addition of a couple comas:

A55. The auditor’s understanding of the entity, and its environment, and the applicable financial reporting framework may also assist the auditor in developing initial expectations about the classes of transactions, account balances, and disclosures that may be significant classes of transactions, account balances, and disclosures. These expected significant classes of transactions, account balances, and disclosures form the basis for the scope of the auditor’s understanding of the entity’s information system.

Restructuring of a sentence in the paragraph for a more fluent sentence:

A59. The auditor’s risk assessment procedures to obtain the required understanding may be less extensive in audits of less complex entities and more extensive for entities that are more complex. The depth of the understanding that is required by the auditor is expected to be less than that possessed by the entity’s management.

Minor grammatical fix and addition of a coma on the first bullet point:

A70. Business risks increasing the susceptibility to risks of material misstatement may arise from the following:

• Inappropriate objectives or strategies, ineffective execution of strategies, or change, or complexity

Grammatical fixes and restructuring of the sentence to make it shorter and easier to read:

A77. Relevant regulatory factors include the regulatory environment which encompasses, among other matters, the applicable financial reporting framework and the legal and political environment and any changes thereto. The following are matters the auditor may consider:

Restructuring from bullet points to alphabetical to better transition and display what the board is trying to say:

A89. Matters that the auditor may consider when obtaining an understanding of the entity’s applicable financial reporting framework and how it applies in the context of the nature and circumstances of the entity and its environment include the following:

a. The entity’s financial reporting practices in terms of the applicable financial reporting framework, such as
(i) accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances, and related disclosures in the financial statements (for example, loans and investments for banks or research and development for pharmaceuticals)
(ii) revenue recognition
(iii) accounting for financial instruments, including related credit losses
(iv) foreign currency assets, liabilities, and transactions
(v) accounting for unusual or complex transactions, including those in controversial or emerging areas (for example, accounting for cryptocurrency)

b. An understanding of the entity’s selection and application of accounting policies, including any changes thereto as well as the reasons therefor, may encompass the following matters:
   (i) The methods the entity uses to recognize, measure, present, and disclose significant and unusual transactions
   (ii) The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus
   (iii) Changes in the environment, such as changes in the applicable financial reporting framework or tax reforms that may necessitate a change in the entity’s accounting policies
   (iv) Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt, or comply with, such requirements

Minor grammatical fix to make it better to understand the message:

A91. The applicable financial reporting framework for a governmental entity may be generally accepted accounting principles established by the Federal Accounting Standards Advisory Board or GASB, or any special purpose framework.

Sentence restructuring to simplify reading and better convey the message without the unnecessary wording. Removed a sentence which basically repeats itself to shorten the paragraph and make it precise:

A93. Understanding the entity, and its environment, and the applicable financial reporting framework assists the auditor in identifying events or conditions, the characteristics of which may affect the susceptibility of assertions about for classes of transactions, account balances, or disclosures to misstatement. These characteristics are inherent risk factors which inherent risk factors may affect susceptibility of assertions to misstatement by influencing the likelihood of occurrence of a misstatement or the magnitude of the said misstatement if it were to occur. Understanding how inherent risk factors affect the susceptibility of assertions to misstatement may assist the auditor with a preliminary understanding of the likelihood or magnitude of misstatements, which assists the auditor in identifying risks of material misstatement at the assertion level in accordance with paragraph 28b. Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement also assists the auditor in assessing the likelihood and magnitude of a possible misstatement when assessing inherent risk in accordance with paragraph 31b. Accordingly, understanding the inherent risk factors may also assist the auditor in designing and performing further audit procedures in accordance with AU-C section 330.
Sentence shortening to make it easier to read and comprehend, making the paragraph more to the point and less confusing:

**A97.** Events or conditions that may affect susceptibility to misstatement due to management bias may also affect susceptibility to misstatement due to other fraud risk factors. Accordingly, this may be relevant information for use in accordance with AU-C section 240,\(^{30}\) which requires the auditor to evaluate whether the information obtained from the other risk assessment procedures and related activities indicates that one or more fraud risk factors are present.

Grammatical fixes as well as sentence restructuring for easier reading for the auditor:

**A101.** For the information system and communication, and the control activities components of the entity’s system of internal control, are primarily more direct in addressing assertion-level risks (see paragraphs A5 and A136). Accordingly, this proposed SAS requires performing risk assessment procedures, beyond inquiry, to evaluate whether the controls identified in accordance with paragraph 26 are effectively designed and determine whether those controls have been implemented (see paragraph 26d). An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. The auditor may identify, in accordance with paragraph 26, direct controls within the other components of the entity’s system of internal control for which the auditor evaluates design and determines implementation (see paragraphs A108 and A165).

Removal of an example that gets explained in the following sentence making it redundant. This makes the paragraph clearer and straight to the point:

**A104.** Auditors of governmental entities often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice or reporting on spending against budget. Auditors of governmental these entities may also have responsibilities to report on compliance with law, regulation, or other authority. As a result, their considerations about the system of internal control may be broader and more detailed.

Sentence restructuring to better tackle the message that’s trying to convey:

**A108.** Indirect controls primarily consist of the controls in the control environment, the entity’s risk assessment process, and the entity’s process to monitor the system of internal control are primarily indirect controls (see paragraph A5). However, controls within these components may vary in nature and precision and, therefore, some controls within these components may also be direct controls that address risks of material misstatement at the assertion level (see paragraph A165).

Minor grammatical fixes to make the paragraph read easier and provide the message more robustly:

**A109.** The control environment provides an overall foundation for the operation of the other components of the system of internal control. The control environment does not directly prevent, or detect and correct misstatements. It may, however, influence the effectiveness of controls in the other components of the system of internal control. Similarly, the entity’s risk assessment process and its process for monitoring the system of internal control are designed to operate in a manner that also supports the entire system of internal control.
Punctuation addition to improve the flow of the paragraph:

A118. Although the control environment may provide an appropriate foundation for the system of internal control and may help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent to fraud. For example, human resource policies and procedures directed toward hiring competent financial, accounting, and IT personnel may mitigate the risk of errors in processing and recording financial information. However, such policies and procedures may not mitigate the override of controls by senior management (for example, to overstate earnings).

Removal of sentences that are unnecessary and don’t add any further explanation to the paragraph:

A119. The auditor’s evaluation of the control environment as it relates to the entity’s use of IT may include such matters as the following:

• Whether governance over IT is commensurate with the nature and complexity of the entity and its business operations enabled by IT, including the complexity or maturity of the entity’s technology platform or architecture and the extent to which the entity relies on IT applications to support its financial reporting

• The management organizational structure regarding IT and the resources allocated (for example, whether the entity has invested in an appropriate IT environment and necessary enhancements or whether a sufficient number of appropriately skilled individuals have been employed, including when the entity uses commercial software [with no or limited modifications])

Grammatical fixes, as well as sentence restructuring adding a period to make it easier to read and convey the message clearer:

A121. Paragraph 22 of this proposed SAS requires the auditor to obtain an understanding of the entity’s process for identifying business risks. AU-C section 240 requires the auditor to make inquiries of management regarding, among other things, management’s process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or as well as classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist.

Minor grammatical changes:

A123. The auditor’s evaluation of the entity’s risk assessment process may assist the auditor in understanding where the entity has identified risks that may occur and how the entity has responded to those risks. The auditor’s evaluation of how the entity identifies its business risks and how it assesses and addresses those risks assists the auditor in understanding whether the risks faced by the entity have been identified, assessed, and addressed as appropriate, appropriately in regards to the nature and complexity of the entity. This evaluation may also assist the auditor with identifying and assessing financial-statement-level and assertion-level risks of material misstatement (see paragraph A107).

Grammatical fixes to better explain how management in smaller entity’s may be performing assessment procedures:

A125. Whether the entity’s risk assessment process is appropriate to the entity’s circumstances, considering the nature and complexity of the entity, is a matter of the auditor’s professional judgment. For example, in some less complex entities, and particularly owner-managed entities, an appropriate
risk assessment may be performed through the direct involvement of management or the owner-manager (for example, the manager or owner-manager may routinely devote time to monitoring the activities of competitors and other developments in the market place to identify emerging business risks). The evidence of this risk assessment occurring in these types of entities is often not formally documented, but it may be evident from, for example, discussions between the auditor and management, corroborated by e-mails or other correspondence between management and other personnel, that management is performing risk assessment procedures.

Removal of sentence that adds extra wording without adding to the message of the paragraph:

A137. The auditor is required to understand the entity’s information system and communication because understanding the entity’s policies that define the flows of transactions and other aspects of the entity’s information-processing activities relevant to the preparation of the financial statements, and then evaluating whether the component appropriately supports the preparation of the entity’s financial statements, supports the auditor’s identification and assessment of risks of material misstatement at the assertion level. This understanding and evaluation may also result in the identification of risks of material misstatement at the financial statement level when the results of the auditor’s procedures are inconsistent with expectations about the entity’s system of internal control that may have been set based on information obtained during the engagement acceptance or continuance process (see paragraph A107).

Removal of words that repeat themselves without furthering explaining the purpose of the paragraph, making it more robust and straight to the point:

A139. As explained in paragraph A55, the auditor’s understanding of the entity and its environment, and the applicable financial reporting framework, may assist the auditor in developing initial expectations about the classes of transactions, account balances, and disclosures that may be significant. In obtaining an understanding of the information system and communication component in accordance with paragraph 25a, the auditor may use these initial expectations for the purpose of determining the extent of understanding of the entity’s information-processing activities to be obtained.

Removal of unnecessary sentence that is already implied in the paragraph itself, not adding any value for the reader:

A145. The information system, and related business processes, in less complex entities are likely to be less sophisticated than in larger entities and are likely to involve a less complex IT environment; however, the role of the information system is just as important. Less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the relevant aspects of the entity’s information system may, therefore, require less effort in an audit of a less complex entity and may involve a greater amount of inquiry than observation or inspection of documentation. The need to obtain an understanding, however, remains important to provide a basis for the design of further audit procedures in accordance with AU-C section 330 and may further assist the auditor in identifying or assessing risks of material misstatement (see paragraph A107).

Grammatical fix to remove a run-on sentence and make the paragraph less confusing:

A146. Included within the entity’s system of internal control are aspects that relate to the entity’s reporting objectives, including its financial reporting objectives, but. This may also include aspects that relate to its operations or compliance objectives, when such aspects are relevant to financial reporting.
Understanding how the entity initiates transactions and captures information as part of the auditor’s understanding of the information system may include information about the entity’s systems and policies designed to address compliance and operations objectives because such information is relevant to the preparation of the financial statements. Further, some entities may have information systems that are highly integrated such that controls may be designed in a manner simultaneously achieve financial reporting, compliance and operational objectives, and combinations thereof.

Minor grammatical fixes and changes to the wording:

A155. The auditor’s understanding of the information system includes the IT environment relevant to the flows of transactions and processing of information in the entity’s information system because due to the entity’s use of IT applications, or other aspects in the IT environment may give rise to risks arising from the use of IT.

Sentence restructuring and grammatical fixes:

A165. Direct controls may exist in the control environment, in the entity’s risk assessment process, or in the entity’s process to monitor the system of internal control, which may be identified in accordance with paragraph 26. An example is a management review control designed to detect misstatements by using key performance indicators, or other types of information, to develop sufficiently precise expectations of reported amounts. The more indirect the relationship between controls that support other controls and the control that is being considered, the less effective that control may be in preventing, or detecting and correcting, related misstatements. For example, a sales manager’s review of a summary of sales activity for specific stores by region is ordinarily is indirectly related only to the risks of material misstatement relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in addressing those risks than controls more directly related thereto, such as matching shipping documents with billing documents.

Grammatical fixes and sentence reduction for better understanding:

A174. Regardless of whether if the auditor plans to test the operating effectiveness of controls that address significant risks, the understanding obtained about management’s approach to addressing those risks may provide a basis for the design and performance of substantive procedures responsive to significant risks as required by AU-C section 330. Although risks relating to significant nonroutine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. For example, when there are nonroutine events, such as a significant business acquisition, consideration of the entity’s response may include such matters as whether it has been referred to appropriate specialists (such as internal or external valuation specialists), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements. The auditor’s understanding of whether the entity has designed and implemented controls for significant risks arising from nonroutine or judgmental matters may include whether and how management responds to the risks. Such responses may include the following:

- Implemented Controls, such as a review of assumptions by senior management or specialists
- Documented processes for accounting estimations
- Approval by those charged with governance
Sentence restructuring to make it less confusing:

**A198. In** When performing a walk-through, at the points at which important processing procedures occur, the auditor *must* inquire of the entity's personnel about their understanding of what is the required by the entity's prescribed procedures and controls, particularly, for the application of manual controls. These inquiries, combined with the other walk-through procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, inquiries that go beyond a narrow focus on the single transaction used as the basis for the walk-through allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Minor grammatical fixes to display a clearer and less confusing message:

**A216.** Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class type of transactions, account balance, or disclosure level (for example, risk of management override of controls). Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. The auditor’s evaluation of whether risks identified relate pervasively to the financial statements supports the auditor’s assessment of the risks of material misstatement at the financial statement level. In other cases, a number of assertions may also be identified as susceptible to the risk and, therefore, may affect the auditor’s risk identification and assessment of risks of material misstatement at the assertion level. For example, the entity faces operating losses and liquidity issues and is reliant on funding that has not yet been secured. In such a circumstance, the financial reporting framework may require management to evaluate whether there is substantial doubt about the entity remaining a going concern, and the auditor may determine that there is a significant risk associated with this determination.

Changed the formatting from bullet points to alphabetical order because of the nature of the paragraph:

**A226.** Significant disclosures include both quantitative and qualitative disclosures for which there is one or more relevant assertions. Examples of disclosures that have qualitative aspects and that may have relevant assertions and, therefore, may be considered significant by the auditor include disclosures about the following:

- *a.* Accounting and reporting complexities associated with an account
- *b.* Exposure to losses in an account
- *c.* Significant contingent liabilities arising from the activities reflected in an account
- *d.* Liquidity and debt covenants of an entity in financial distress
- *e.* Events or circumstances that have led to the recognition of an impairment loss
- *f.* Key sources of estimation uncertainty, including assumptions about the future
- *g.* The nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework, where, for example, new financial reporting
requirements are expected to have a significant impact on the financial position and financial performance of the entity

h. Share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures

i. Related parties and related party transactions

j. Sensitivity analysis, including the effects of changes in assumptions used in the entity’s valuation techniques intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount

Sentence restructuring and minor grammatical fixes:

**A244.** Due to the nature of a risk of material misstatement, and the control activities that address that risk, in some circumstances, the only way to obtain sufficient appropriate audit evidence is to test the operating effectiveness of controls. Accordingly to **AU-C section 330**, there is a requirement for the auditor to identify any such risks because of the implications for the design and performance of further audit procedures in accordance with **AU-C section 330** to address risks of material misstatement at the assertion level.