November 24, 2020

Ms. Sherry Hazel  
American Institute of Certified Public Accountants  
1345 Avenue of the Americas, 27th Floor  
New York, NY 10105  
USA

Re: Proposed Statement on Auditing Standards, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Dear Ms. Hazel:

Deloitte & Touche LLP (“D&T,” “our,” or “we”) appreciates the opportunity to respond to the request for public comment from the Auditing Standards Board (ASB or Board) of the American Institute of Certified Public Accountants (AICPA) on its proposed Statement on Auditing Standards (SAS), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (“proposed SAS”).

**Overall Comment**

We are fully supportive of the ASB’s proposal to converge with International Standard on Auditing 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement* (ISA 315 (Revised)), which was recently issued by the International Audit and Assurance Standards Board (IAASB). We agree with the changes made by the ASB to ISA 315 (Revised) to develop the proposed SAS in those instances where the changes address circumstances and requirements specific to the U.S. and AICPA Professional Standards. However, in an effort to maximize convergence efforts, we have identified matters within the proposed SAS that result in differences with ISA 315 (Revised) that we believe should be eliminated. It is our view that the matters identified, as outlined within Appendix II, create unnecessary differences between ISA 315 (Revised) and the proposed SAS and are not needed as they are not related to circumstances unique to the U.S. environment.

**Specific Comments**

Our responses to the questions posed in the Explanatory Memorandum, specific instances of changes recommended related to our overall comment on convergence, proposals to improve clarity and understandability, and editorial suggestions are included in the following appendixes:

- **Appendix I** — Request for Comment by the ASB.
- **Appendix II** — Convergence Recommendations.
- **Appendix III** — Clarification and Understandability Recommendations.
- **Appendix IV** — Editorial Recommendations.
In the appendixes, any recommendations for wording changes are highlighted as follows:

- Additions are noted in **bold underline**.
- Deletions are noted in **strikethrough text**.

The markup of the paragraphs within each Appendix follows the same numerical sequence or ordering of sections as structured in the proposed SAS. All proposed edits assume the amendments in the proposed SAS (including conforming amendments) are accepted by the ASB as final.

* * * * *

We would be pleased to discuss our letter with you at your convenience. If you have any further questions, please contact Tania Sergott at (203) 563-2616.

Sincerely,

Deloitte & Touche LLP
Appendix I — Request for Comment by the ASB

Below are our responses to the requests for specific comments by the ASB.

Scalability

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. D&T acknowledges the ASB’s commitment to including scalability within the proposed SAS and believes the proposed SAS is capable of being applied to the audits of entities with a wide range of sizes, complexities, and circumstances.

Controls That Address the Risks of Material Misstatement

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:

(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. D&T is supportive of the enhanced requirements and related guidance on obtaining an understanding of the entity’s system of internal control to inform the risk identification and assessment process. We believe that obtaining an understanding of the entity’s system of internal control, including the IT environment, is essential to the risk assessment process due to the significant use of technology by entities. D&T believes that the proposed standard appropriately outlines why the understanding of an entity’s system of internal control is obtained and how the auditor’s understanding of the entity’s system of internal control 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?

Yes. D&T believes the requirements related to an auditor’s identification of relevant controls that address risks of material misstatement have been appropriately enhanced and clarified.

(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. D&T believes that the terminology in paragraphs 21–27 and the related application material in the proposed SAS are capable of consistent interpretation for audits of entities that use the COSO framework.

Enhanced Guidance Related to IT

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. D&T believes 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 is sufficiently 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.

**Identifying and Assessing the Risks of Material Misstatement**

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. D&T is supportive of the definitions of significant classes of transactions, account balances, and disclosures and their relevant assertions and believes the definitions are sufficiently clear to assist the auditor in identifying where the risks of material misstatement exist.

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

Yes. D&T is supportive of the introduction of the spectrum of inherent risk in the proposed SAS.

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

Yes. D&T supports the separate assessment of inherent risk and control risk in relation to all risks of material misstatement at the assertion level. The separate assessment of inherent risk and control risk allows for a more granular risk assessment. We believe that it is imperative that the control risk be evaluated separately from the inherent risk for each risk of material misstatement at the assertion level due to the intrinsic differences in these two types of risk.

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?

D&T believes the requirement to assess the control risk is sufficiently clear. The enhancements make it clear that control risk is assessed at the maximum when the auditor does not plan to test the operating effectiveness of controls. That is, control risk cannot be reduced based on the effective operation of controls unless the auditor intends to test them.

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)?

D&T believes the requirements in paragraph 26d of the proposed SAS are clear, including the requirements specific to controls over journal entries.

**Significant Risks**

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?

Yes. D&T supports the revised definition, and related material, on the determination of significant risks. D&T’s view is that it is important to retain the concept of, and requirement to, determine significant risks. D&T is supportive of aligning the definition of significant risk with the guidance for a relevant assertion in paragraph A11, that is the definition should be a combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement.
Stand-Back and Paragraph .18 of AU-C section 330

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?

D&T supports the proposed stand-back requirement in paragraph 36 of the proposed SAS because we believe it enhances the iterative nature of the proposed SAS, as well as supports AU-C section 330, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained, which requires that the auditor reassess risk assessment conclusions reached (e.g., as new information is obtained that may inform or contradict previous conclusions).

The requirements and guidance in the proposed SAS drive a robust, risk-based approach that allows the auditor to better tailor procedures based on the reasons for the assessed risks of material misstatement. The robust risk assessment procedures within the proposed SAS also enable the auditor to identify, that while greater than materiality, there may be classes of transactions, account balances, or disclosures for which no reasonable possibility of material misstatement exists. We agree that requiring substantive procedures for each “material” class of transactions, account balance, and disclosure where there is no reasonable possibility of material misstatement results in procedures that are inadequately tailored and unnecessary.

However, while D&T is supportive of the conforming amendments proposed to paragraph .18 of AU-C section 330, we question the appropriateness of the requirement to perform substantive procedures for each of the relevant assertions of each significant class of transactions, account balance, and disclosure. D&T believes that in today’s increasingly automated environments, and considering the new automated tools and techniques (including data analytics) used to perform audit procedures, the discrete classification of audit procedures as either risk assessment procedures, tests of controls, or substantive procedures becomes more challenging. The auditor should be focusing on whether sufficient appropriate audit evidence for a relevant assertion has been obtained; the “classification” of the procedures that resulted in such evidence should not be a focus.

Considering that the use of technology at entities is becoming more extensive, and the initiation and execution of transactions is becoming increasingly digital; the importance of effective operation of controls to prevent and detect material misstatements cannot be understated. Therefore, requiring that substantive procedures be performed for each relevant assertion when evidence of the operating effectiveness of controls provides more persuasive evidence, does not seem to benefit audit quality. As an example, an entity in the digital advertising and technology industry may purchase and sell ad impressions and track these transactions through their IT system as revenue recognition is met. In this scenario, audit evidence primarily consists of internal information from the entity’s IT system as there is no reliable third-party evidence (e.g., the advertisers and publishers do not have the ability to independently track their purchases and sales data using internally developed software, and there are no third-party impression trackers). In this circumstance, we believe the most appropriate procedure to address the occurrence assertion is testing the operating effectiveness of controls – and we believe that this procedure provides sufficient appropriate audit evidence for this assertion. We recommend that the ASB reconsider the need to always obtain evidence from substantive procedures, for all relevant assertions, and instead revise the proposed SAS to focus on the auditor standing back and evaluating whether the procedure(s) performed provide sufficient and appropriate audit evidence to address each relevant assertion, regardless of the category or type of procedure that is performed.

Audit Documentation

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

D&T believes the documentation requirements in the proposed SAS are clear and appropriate.
Appendix II — Convergence Recommendations

As outlined within our cover letter, we fully support the ASB’s efforts to align the proposed SAS with the recently released ISA 315 (Revised) and recognize that this is part of the ASB’s broader strategic objective to converge its standards with those of the IAASB. The ASB’s initiative to strive for convergence is rooted in a recognition of the pervasiveness of international business activity and the fact that its standards are being implemented by auditors who are also using the ISAs and the standards of the PCAOB. We believe that having wording differences between the SASs and the ISAs, even for “simple terminology,” causes confusion in practice, and confusion reduces effective implementation.

To stay as closely harmonized with the IAASB as possible, we strongly suggest the ASB challenge each of the edits made to ISA 315 (Revised) in developing the proposed SAS and not update terminology unless the intent of such update is to change the meaning of the proposed standard and/or the procedures intended to be performed by the auditor. While differences in wording between ISA 315 (Revised) and the proposed SAS may be perceived by the ASB to be “for the sake of clarity or readability,” users of these standards would benefit from consistency when no difference is meant.

The edits noted below to reverse changes made by the ASB to ISA 315 (Revised) are those that we believe are most significant and create unnecessary differences between ISA 315 (Revised) and the proposed SAS, and for which the proposed SAS has not provided information as to the reasoning for the change.

We propose the following edits:

12. For purposes of GAAS, the following terms have the meanings attributed . . .

   General information technology (IT) controls. Controls over the entity’s IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information-processing controls and the integrity of information (that is, the completeness, accuracy and validity of information) in the entity’s information system. Also see IT environment. (Ref: par. A6)

   Information-processing controls. Controls relating to the processing of information in IT applications or manual information processes in the entity’s information that directly address risks to the integrity of information (that is, the completeness, accuracy and validity of transactions and other information). (Ref: par. A6–A7)

   Risks arising from the use of IT. Susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information (that is, the completeness, accuracy and validity of transactions and other information) in the entity’s information system, due to ineffective design or operation of controls in the entity’s IT processes. See IT environment. (Ref: par. A6 and A12)

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

A61. The entity’s use of IT and the nature and extent of changes in the IT environment, including the risks arising from the use of IT, may also affect the specialized skills that are needed to assist with obtaining the required understanding.

Additional context on requested edit: We suggest a phrase be removed from paragraph A61, as inclusion of
this phrase implies that the auditor has already identified risks arising from the use of IT, when the requirement related to this application material paragraph is about understanding the entity and its environment.

A85. The procedures undertaken to understand the entity’s measures may vary depending on the size or complexity of the entity as well as the involvement of owners or those charged with governance in the management of the entity. **Examples follow:**

- **For some less complex entities, the terms of the entity’s bank borrowings (i.e., bank covenants) may be linked to specific performance measures related to the entity’s performance or financial position (e.g., a maximum working capital amount).** The auditor’s understanding of the performance measures used by the bank may help identify areas where there is increased susceptibility to the risk of material misstatement.

- **For some entities whose nature and circumstances are more complex, such as those operating in the insurance or banking industries, performance or financial position may be measured against regulatory requirements (e.g., regulatory ratio requirements such as capital adequacy and liquidity ratios performance hurdles).** The auditor’s understanding of these performance measures may help identify areas where there is increased susceptibility to the risk of material misstatement.

A106. **The overall objective and scope of** the requirements of the auditor to obtain sufficient appropriate audit evidence in an audit does not differ whether an entity operates in a mainly manual environment, a completely automated environment, or an environment involving some combination of manual and automated elements (that is, manual and automated controls and other resources, including service organizations, used in the entity’s system of internal control).

A107. **In evaluating the effectiveness of the design of controls and whether they have been implemented the auditor’s understanding of each of the components of the entity’s system of internal control provides a preliminary understanding of how the entity identifies business risks relevant to financial reporting and how it responds to them.** It may also influence the auditor’s identification and assessment of the risks of material misstatement in different ways (see paragraph A94). The auditor’s identification and assessment of the risks of material misstatement assists the auditor in designing and performing further audit procedures, including any plans to test the operating effectiveness of controls. Examples follow: . . .

A114. The auditor’s evaluation of how the entity demonstrates behavior consistent with the entity’s commitment to integrity and ethical values; whether the control environment provides an appropriate foundation for the other components of the entity’s system of internal control; and whether any identified control deficiencies undermine the other components of the system of internal control, assists the auditor in identifying potential issues in the other components of the system of internal control as well as the controls the auditor might identify in accordance with paragraph 26. This is because the control environment is foundational to the other components of the entity’s system of internal control. This evaluation may also assist the auditor in understanding risks faced by the entity and, therefore, in identifying and assessing the risks of material misstatement at the financial statement and assertion levels (see paragraph A107).

A120. As explained in paragraph A69, not all business risks give rise to risks of material misstatement, whether due to error or fraud. In understanding how management and those charged with governance have identified business risks relevant to the preparation of the financial statements, and decided about actions to address those risks, matters the auditor may consider include how management or, as appropriate, those charged with governance, has done the following:

- Specified the entity’s objectives with sufficient precision and clarity to enable the identification and assessment of the risks relating to the objectives

- Identified the risks to achieving the entity’s objectives and analyzed the risks as a basis for determining how the risks should be managed
A142. The auditor’s assessment of inherent risk may also influence the identification of controls in the control activities component. For example, the auditor’s identification of controls relating to that address significant risks may only be identifiable only when the auditor has assessed inherent risk at the assertion level in accordance with paragraph 31. Furthermore, controls addressing risks for which the auditor has determined that substantive procedures alone do not provide sufficient appropriate audit evidence (in accordance with paragraph 33) may also only be identifiable only once the auditor’s inherent risk assessments have been undertaken.

A164. The auditor’s identification and evaluation of controls in the control activities component is focused on information-processing controls, which are controls applied during the processing of information in the entity’s information system that directly address the risks of material misstatement. This may include risks arising from IT such as risk relating to the integrity of information (that is, the completeness, accuracy, and validity of transactions and other information). However, the auditor is not required to identify and evaluate all information-processing controls related to the entity’s policies that define the flows of transactions and other aspects of the entity’s information-processing activities for the significant classes of transactions, account balances, and disclosures.

A174. Regardless of whether 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 330.40. 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 one-off events such as the receipt of a notice of a significant lawsuit, consideration of the entity’s response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), 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. Additionally, 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:

- Controls, such as a review of assumptions by senior management or specialists
- Documented processes for accounting estimations
- Approval by those charged with governance.

Additional context on requested edit: We suggest paragraph A174 retain the example of a significant lawsuit from ISA 315 (Revised) paragraph A158. If the ASB feels an example specific to a nonroutine event, such as a significant business acquisition, is needed, we suggest an additional example be added to paragraph A174 with wording tailored to be specific to a business acquisition, as we do not believe it is clear how “an assessment has been made of the potential effect” relates to a business acquisition.

A176. Controls that address risks of material misstatement at the assertion level that are expected to be identified for all audits are controls over journal entries, because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or nonstandard, or automated or manual. Paragraph 25a requires the auditor to obtain an understanding of the flows of information in the entity’s information system for significant classes of transactions, account balances, and disclosures. The understanding required by paragraph 26a(ii) includes controls over adjustments to significant classes of transactions, account balances, and disclosures that may not.
be subject to controls over processing of routine transactions. The extent to which other controls are identified may vary based on the nature of the entity and the auditor’s planned approach to further audit procedures. For example, in an audit of a less complex entity, the entity’s information system may not be complex and the auditor may not plan to rely on the operating effectiveness of controls. Further, the auditor may have identified no related party transactions that meet the definition of significant unusual transactions in accordance with AU-C section 240A, nor have identified any significant risks or any other risks of material misstatement for which it is necessary for the auditor to evaluate the design of controls and determine that they have been implemented. In such an audit, the auditor may determine that there are no identified controls other than the entity’s controls over journal entries.

Additional context on requested edit: The changes made in paragraph A176 of the proposed SAS from ISA 315 (Revised) that refer to paragraphs 25 and 26 are repetitive of the content of paragraphs 25 and 26 and are not necessary. In addition, we believe the example provided by the IAASB in paragraph A160 of ISA 315 (Revised) assists users with scalability of the proposed SAS for less complex entities. If the ASB concludes that the differences between ISA 315 (Revised) should be retained, the reference to AU-C section 240 should be updated to AU-C section 550 to be consistent with footnote 57.

A184. Understanding the risks arising from the use of IT and the general IT controls implemented by the entity to address those risks may affect some or all of the following: . . .

- The auditor’s strategy for testing information produced by the entity that is produced by or involves information from the entity’s IT applications. For example, when information produced by the entity to be used as audit evidence is produced by IT applications, the auditor may determine to test controls over system-generated reports, including identification and testing of the general IT controls that address risks of inappropriate or unauthorized program changes or the integrity of the direct data changes to that appears in the reports. . . .

A187. The controls identified by the auditor may depend on system-generated reports, in which case, the IT applications that produce those reports may be subject to risks arising from the use of IT. In other cases, the auditor may not plan to rely on controls over the system-generated reports and plan to directly test the inputs and outputs of such reports the report generation process, in which case, the auditor may not identify the related IT applications as not being subject to risks arising from IT and, thus, these controls may not be subject to the requirements in paragraphs 26c–d.

A203. In performing the evaluations of each of the components of the entity’s system of internal control, as described in paragraphs .21b, .22b, .24c, .25c, and .26d, the auditor may determine that certain of the entity’s policies in a component are not appropriate to the nature and circumstances of the entity. Such a determination may be an indicator that assists the auditor in identifying control deficiencies. If the auditor has identified one or more control deficiencies, the auditor may consider the effect of those control deficiencies on the design of further audit procedures in accordance with AU-C section 330.

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 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 auditor may determine that the going concern basis of accounting gives rise to a risk of material misstatement at the financial statement level. In this situation, the accounting framework may need to be applied using a liquidation basis, which would likely affect all assertions pervasively, 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.

Additional context on requested edit: In the example provided in the proposed SAS in paragraph A216, it is unclear why the auditor determined there to be a significant risk, as the application paragraph is about identifying risks of material misstatement at the financial statement level, not assessing inherent risk. The IAASB’s example better illustrates a risk of material misstatement that is pervasive to the financial statements as a whole and potentially affects many significant accounts. In addition, the terminology used by ISA 315 (Revised) is consistent with that of AU-C 570.

A240. The determination of significant risks allows for the auditor to focus more attention on those risks that are on the upper end of the spectrum of inherent risk, through the performance of certain required responses, including the following: . . . .

A262. More detailed documentation that is sufficient to enable an experienced auditor having no previous experience with the audit to understand the nature, timing, and extent of the audit procedures performed and a conclusion or the basis for a conclusion not otherwise readily determinable from the documentation of the work performed or audit evidence obtained may be required to support the rationale for difficult judgments made. An example of such a circumstance may be the rationale for significant judgments related to the inherent risk of an identified risk of material misstatement, when such rationale is not otherwise evident from the audit documentation.

Consistent with the convergence recommendations above, we propose changes to the conforming amendments made to various AU-C sections of the proposed SAS, as noted below.

AU-C section 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards

A45 GAAS typically refer to the risks of material misstatement, rather than inherent risk and control risk separately. However, AU-C section 315 requires inherent risk to be assessed separately from control risk to provide a basis for designing and performing audit procedures to respond to the assessed risks of material misstatement at the assertion level in accordance with AU-C section 330. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

AU-C section 240, Consideration of Fraud in a Financial Statement Audit

A49 When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters may be relevant:

. . .

• The entity’s financial reporting process and the nature of evidence that can be obtained. For many entities, routine processing of transactions involves a combination of manual and automated controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls . . . .

AU-C section 265, Communicating Internal Control Related Matters Identified in an Audit

.02 The auditor is required to obtain an understanding of the entity’s system of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers the entity’s system of internal control in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of
The auditor may identify control deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This section specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

**AU-C section 330, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained**

.07 In designing the further audit procedures to be performed, the auditor should

a. consider the reasons for the assessed risk of material misstatement at the relevant assertion level for each significant class of transactions, account balance, and disclosure, including

   i. the likelihood and magnitude of material misstatement due to the particular characteristics of the significant class of transactions, account balance, or disclosure (the inherent risk) . . . .

.14 If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor should perform audit procedures to establish the continuing relevance and reliability of that information to the current audit . . . .

**AU-C section 402, Audit Considerations Relating to an Entity Using a Service Organization**

.10 When obtaining an understanding of the entity's system of internal control relevant to the audit in accordance with section 315 fn 1 the user auditor should identify controls in the control activities component at the user entity from those that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization, and evaluate their design and determine whether they have been implemented. fn 2

.12 If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor should obtain that understanding from one or more of the following procedures:

a. Obtaining and reading a type 1 or type 2 report, if available

b. Contacting the service organization, through the user entity, to obtain specific information

c. Visiting the service organization and performing procedures that will provide the necessary information about the relevant controls at the service organization

d. Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization (Ref: par .A15-.A20)

*Additional context on requested edit:* The conforming amendments within ISA 315 (Revised) remove “relevant” from procedure d. It is our view that the term “relevant controls” should be consistently applied to both procedures c and d.

**AU-C section 550, Related Parties**

.A30 Relevant related party information shared with the engagement team members may include the following:

- The nature of the related party relationships and transactions

- Significant or complex related party relationships or transactions that may be determined to be associated with significant risks, particularly transactions in which management or those charged with governance are financially involved.
AU-C section 540, Auditing Accounting Estimates and Related Disclosures

.05 This section refers to relevant requirements in AU-C sections 315 and 330 and provides related guidance to emphasize the importance of the auditor’s decisions about controls relating to accounting estimates, including decisions about whether

- there are controls required to be identified by identified in accordance with paragraph .27 of AU-C section 315, for which the auditor is required to evaluate their design and determine whether they have been implemented.

- to test the operating effectiveness of relevant controls.

.A39 Management may design and implement specific controls around models used for making accounting estimates, whether it’s management’s own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified as relevant to the audit. When complexity in relation to models is present, controls over data integrity are also more likely to be identified controls in accordance with paragraph .27 of AU-C section 315. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and related identified controls include the following: . . . .

Additional context on requested edit: Paragraph 27 of AU-C section 315 appears to be the incorrect reference as this paragraph relates to control deficiencies within the entity’s system of internal control.

.A51 As part of identifying the controls, and evaluating their design and determining whether they have been implemented, the auditor may consider the following . . . .
Appendix III — Clarification and Understandability Recommendations

We recommend the edits noted below to the Application and Other Explanatory Material for clarification and understandability.

We suggest paragraph A242 be revised to clarify that a related-party transaction *that is also a significant unusual transaction* would give rise to a significant risk in accordance with AU-C section 550. The wording of the proposed SAS implies that *all transactions with related parties* are required to be identified as significant risks. The suggested language below can be used to clarify the requirement.

A242. The determination of which of the assessed risks of material misstatement are close to the upper end of the spectrum of inherent risk, and, therefore, are significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk in accordance with requirements of another AU-C section. AU-C section 240 and AU-C section 550 provide further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud and transactions with related parties. Examples are as follows: . . .

We suggest paragraph A243 be revised to remove the reference to accounting for unusual or complex transactions in emerging areas. If the ASB feels it is necessary to include emerging areas in this application material paragraph, we suggest the ASB move emerging areas to a separate bullet and clarify the definition of emerging areas.

A243. The auditor also takes into account the relative effects of inherent risk factors when assessing inherent risk. The lower the effect of inherent risk factors, the lower the assessed risk is likely to be. Risks of material misstatement that may be assessed as having higher inherent risk and, therefore, may be determined to be a significant risk, may arise from matters such as the following:

- Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved
- Accounting estimates that have high estimation uncertainty or complex models
- Accounting for unusual or complex transactions, including those in controversial or emerging areas (for example, accounting for revenue with multiple performance obligations that are difficult to value)
- Complexity in data collection and processing to support account balances
- Account balances or quantitative disclosures that involve complex calculations
- Accounting principles that may be subject to differing interpretation
- Changes in the entity’s business that involve change in accounting, for example, mergers and acquisitions.

We suggest the example in paragraph A252 be clarified to state that only operating effectiveness testing would be ineffective in this scenario. The auditor’s design and implementation testing may assist in evaluating the severity of internal control deficiencies or in designing further audit procedures.

A252. Regardless of whether the auditor plans to test the operating effectiveness of controls for the purpose of assessing control risk, the auditor’s understanding of the entity and its environment, the financial reporting framework, and the entity’s internal control informs the auditor’s design of further audit procedures. Examples follow:

- The auditor’s understanding of internal control may indicate that controls are not designed or
implemented appropriately, or the entity’s control environment does not support the effective operation of control. In this case, there is no point in testing the **operating effectiveness of** controls; the further audit procedures will consist solely of substantive procedures. If the auditor determines, pursuant to paragraph 33, that substantive procedures alone cannot provide sufficient appropriate audit evidence, the auditor may need to consider the effect on the auditor’s report, as described in AU-C section 330.

- The auditor’s understanding of the entity’s information system and communication will inform the auditor about the nature of documentation available for testing. For example, if the entity’s records are all electronic, the auditor may design audit procedures differently than if the entity’s records are in paper format.
Appendix IV — Editorial Recommendations

We recommend the following edits to the Application and Other Explanatory Material:

- Paragraph 5 — The reference to application paragraph 107 should be updated to application paragraph 108.
- Paragraph 67 — The reference to Appendix B should be removed.
- Paragraph 93 — The reference to paragraph 31b should be updated to paragraph 31a.
- Paragraph 183 — The reference to paragraph 26b(ii) should be updated to paragraph 26c(ii).
- Paragraph A191 — The reference to Appendix E should be removed.
- Subtitle in application material “Risks of Material Misstatement at the Financial Statement Level” — The reference to paragraph 29 should be updated to paragraph 30.
- Paragraph A217 — The reference to paragraph 26c should be updated to paragraph 25c.