November 25, ‘20

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

To the Auditing Standards Board

I am the Managing Partner of a learning and development consulting firm. Audit practices have frequently engaged us to address issues related to risk assessment, and those experiences have lead us to believe that the most significant root causes of poor auditor risk assessment are:

• An over reliance on prior year’s audits, driven by a failure to identify changes in the business and the industry.

• A lack of understanding of the purpose of risk assessment procedures and how the various elements of the risk assessment process connect to each other.

An improvement in just these two areas can significantly improve auditor performance, and these will be the focus of our comments.

Change, Inherent Risk, and the Reliance on Work Performed in Prior Audits

Request for Comment #5 and #10
Paragraphs 16, A43 - A45, A92 - A94; Appendix B

The enhanced guidance on inherent risk and inherent risk factors is a welcome addition to the auditing standards.

You have specifically asked for comments regarding the introduction of “a spectrum of inherent risk.” We are not sure what practice problem this concept is intended to address, but if the Board has received feedback that auditors are assessing risk the same for all accounts and assertions in the financial statements, then this guidance should help. We believe that if auditors are indeed performing a blanket assessment of inherent risk, then the root cause of the problem is a lack of understanding of the risk assessment process, which may be more effectively addressed through other guidance in the proposed standard.

We are more enthusiastic about the choice to include change as an inherent risk factor. Months can pass between the completion of the prior year audit and the start of planning for the current year’s. During that time, when auditors frequently lose contact with their clients, much can change, and these changes can have a significant impact on both inherent and control risk.

A core affliction of many engagement team’s risk assessment process is its inability to identify and assess change. By explicitly directing auditors to identify and evaluate the impact that change has on inherent risk the standards should improve practice.
We encourage the Board reinforce the need to assess change by making the following enhancements.

- Expand the discussion of change in Appendix B, paragraph 2
- Reframe the requirements of paragraph 16
- Reconsider and expand the guidance in appendix A paragraph 2 and linking that guidance to Appendix B, paragraph 2

**Expanded discussion of change in Appendix B**

The proposed standard frames change in the context of inherent risk, a position that is consistent with our own. The auditor’s task is not just to identify change, but to evaluate its impact at the assertion level. Including change as an inherent risk factor accomplishes that objective.

We generally agree with the description of change included in Appendix B paragraph 2 and find it clear and helpful. We believe the guidance could be more impactful and efficient if it were to include additional insights.

The auditor should be particularly alert for changes that are difficult to identify.

Appendix B notes two types of changes: 1) events and 2) conditions that evolve over time. This distinction is important because auditors are much more likely to identify discrete events (e.g., the acquisition another entity) than they are to identify changes that occur over time (e.g., the effects of implementing a strategic plan). Similarly, changes that are internal to the entity generally are easier to identify than external changes in the general business environment.

Our discussions with clients have revealed many situations where auditors did not discover risks until late in the audit process because they were related to change that was either gradual or external to the entity. Alerting auditors to conditions where identifying change may be difficult has been helpful.

For this reason, we would support an explicit statement highlighting the challenges of identifying certain types of change. Amending paragraph A71 to include examples of gradual change would also be helpful.

A lack of change where one is warranted may create risk.

Auditors can get caught in the trap of observing that “nothing has changed” without asking “should change have occurred?” Consider, changes in market demand that affect the entity’s inventory valuation. The auditor may assess inherent risk based on the knowledge that the entity’s inventory valuation process is the same as last year without assessing the changes to that process that should have been made given the evolving business environment.

Paragraph A70 addresses the implications of a lack of anticipated change but only in the context of business risk. We encourage an addition to Appendix B, paragraph 2 to expand this concept to the assessment of inherent risk.

Inconsistent change across the business model may create risk.

For example, the entity may grow and its business model become more complex but the enhancements to its systems and the development of the skills of its
personnel may lag behind. These gaps between an entity’s evolving business model and its capabilities can create risk.

We have seen many examples of this circumstance, most commonly where an entity continued to operate a legacy IT system long after its business model had rendered it inadequate.

**Change can reduce risk**

Many auditors are reluctant to reduce risk. For example, consider an asset that is valued based on future cash flows that in turn depend on assumptions about the entity’s ability to effectively cut costs. Initially, the lack of an operating history will create uncertainty, which supports increased inherent risk. But over time, the results of the cost cutting strategy come into focus, uncertainty diminishes and—if the plan was effective—inherent risk is reduced.

Reminding practitioners that change can both increase or decrease inherent risk will reinforce the notion of a spectrum on inherent risk and improve their risk assessment.

**Reframing the guidance in paragraph 16**

The guidance in paragraph 16 directly addresses the use of information from prior year’s work papers. This paragraphs has been carried forward almost verbatim from existing 315.10. In spite of this guidance, many audit teams continue to over rely on information from prior year’s audits, which suggests to us that a re-examination of proposed paragraph 16 is in order.

The underlying principle of paragraph 16 is that circumstances change between audits, which may render some of the information from prior year’s irrelevant for assessing risk in the current period. The paragraph frames the “updating” of prior year’s information as a matter of audit evidence and whether the information meets the criteria of relevance and reliability. While this positioning is conceptually sound we find the reasoning overly complex and the introduction of the principles of audit evidence into guidance on understanding the entity to be jarring.

Rather than frame this guidance as a matter of audit evidence, it seems more direct and consistent to use the inherent risk construct described in Appendix B to frame the requirements of paragraph 16. For example, guidance such as the following may be helpful .

> When the auditor intends to use information obtained from the auditor’s previous experience with the entity and from audit procedures, including risks assessment procedures, performed in previous audits, the auditor should identify and evaluate changes at the entity and in its environment to determine whether such information remains relevant and reliable as a basis for assessing inherent risk (Ref: Appendix A; Appendix B, par. 2)

Note that modifying the standard in this way also would require a similar change to paragraph A22.

**Linking business risk to inherent risk**

In our experience, creating a logical link between the entity and inherent risk is the single most difficult part in the risk assessment process. Typically, auditors
dutifully document a collection facts about the entity and its environment. But that information remains siloed and disconnected from other elements of the risk assessment process.

Paragraph A68 explains that understanding an entity’s business model is useful because it helps auditors understand business risks and that understanding the **business risks that have an effect on the financial statements** will help identify risks of material misstatement.

The challenge for most auditors is in determining how business risks translate into audit risks at the entity or financial statement level. Additional guidance on how to make this connection would help solve a significant practice problem.

**The importance of understanding the entity’s strategy**

Auditors sometimes struggle to gather information about the entity and its environment that is relevant to the financial statement audit. They may fail to identify information that is significant or identify too much information that has no bearing on the financial statements.

Audit methodologies drive auditors to identify the myriad of examples provided in the standards but the work papers merely accumulate this information in a way that lacks coherence and seems to exist independent of the risk assessment process.

In our experience, what auditor’s have found most helpful is to suggest they focus on strategy as a productive first step in determining what information about the entity and its environment is most relevant and why. Our observations are:

- Auditors frequently find it difficult to determine what information about the industry is relevant to their client during the period covered by the audit. Company management is in the best position to comment on industry dynamics and how the entity should operate in that environment to be successful.

  In practice, the most effective way for auditors to unlock management’s knowledge and gather the most relevant information about the industry is for them to ask management about the entity’s business strategies.

- Strategy drives change **over time**, which (as discussed above) is difficult for auditors to identify. Auditors that have an understanding of the entity’s business strategies will be better equipped to identify gradual change over time and make the necessary adjustments to their risk assessment.

  For example, the entity’s strategy may include introducing a new product to the market. In the first year or two the revenue from those new products may be insignificant and fall under the auditor’s radar. If the strategy works, over time the revenue from the new product will grow, and that revenue stream could become a significant class of transactions.

- Changes over time may affect control risk. The capabilities of information systems and the design of controls frequently lag changes to the entity’s business model. This lag can create gaps in the internal control system where emerging financial statement risks are not sufficiently mitigated.
We believe the guidance in paragraphs 67 - 72 would be more impactful if it was expanded to

- Note that business strategies will drive change over time and that auditors need to consider all change, including gradual change over time when assessing inherent risk.

- Understanding the entity’s business strategies can be helpful in understanding which aspects of the industry and the entity’s business model are most relevant (an issue identified in paragraph A69 that does not seem to be resolved).

If these paragraphs are modified to incorporate these ideas, then we believe that paragraph 2 of Appendix A should also change.

The “Why” Guidance
Numerous A. paragraphs

The application materials clearly and consistently explain why certain procedures are important and how they relate to each other. These explanations are an extremely useful addition to the auditing standards, and we encourage the Board to continue to provide this “why” guidance in its standards.

At its core, the auditor’s risk assessment process is an exercise in critical thinking. The mere gathering and documentation of information is easy. Far more difficult is the evaluation of that information and its implications for other steps in the audit.

In practice, what we’ve observed is the tendency of auditors to gather the information suggested in the standards but then leave that information siloed. This inability to understand how various pieces of information fit together is one of the primary causes of poor risk assessment.

The “why” guidance in the proposed standard lays out a roadmap for how auditors should sort through all the information they have gathered, determine what’s relevant, and then connect the dots.

This visibility into the ASB views will be enormously helpful to learning professionals as we look to create effective learning experiences, including case studies, simulations and other learning activities that allow auditors to experience the application of the standard’s guidance in a classroom setting before applying it on an actual audit.

Other Matters
Internal Control,
Request 2a, paragraphs A98 - A204

In our discussions with audit firms, the most frequently cited reasons why auditors underperform in their evaluation of internal control are:

- A general lack of understanding of the relevance of internal control to the audit. A mindset continues to persist—among a small but influential group—that the only thing that matters in an audit is substantive testing.

- A belief that expending resources to understand and assess internal control can not be cost-justified. As a result, performing critical control risk
assessment procedures like walkthroughs or an evaluation of management review controls is delegated to the least experienced audit team members.

- An uncertainty about how to respond if the auditor finds the entity’s internal control to be poorly designed or implemented.

- A lack of experience and understanding of information systems (we’ve noted that auditors with operational experience in the accounting department of an organization are much better at understanding and applying the guidance related to internal control than those whose experience is solely as an auditor in public practice)

I did not read paragraphs A98 - A204 in-depth but instead concentrated on those matters for which we have been most frequently asked to develop skills training. What I did read was impressive in its clarity and insight.

Yet, it is not enough. Changing auditor behavior with regard to internal control is a complex undertaking that requires changing mindsets, developing skills, improving methodologies and possibly re-thinking service delivery models. Thoughtful standards that provide transparency into the intent and thinking of the standards setters are the necessary starting point.

As one who develops case studies and experiential learning experiences, I know this guidance will be extremely valuable the next time we are asked to help firms improve their audit teams’ understanding and assessment of controls.

**Request 7, paragraph 34**

The intent of this paragraph was not immediately clear. I have interpreted this paragraph to say that in those situations where the auditor will not test operating effectiveness, if the auditor assesses inherent risk to be “high,” for reasons X, Y and Z, then the overall risk of material misstatement should also be assessed high for reasons X, Y and Z. If the auditor assesses inherent risk to be “moderate,” for reasons A and B, then the overall risk of material misstatement should also be assessed moderate for reasons A and B.

In other words, when the auditor does not test operating effectiveness, for the purposes of assessing risk, the auditor must assume that internal controls have no impact on the overall risk of material misstatement and therefore inherent and RMM are the same.

What is confusing is the phrase “the auditor’s assessment of control risk should be such that …” In practice, many auditors take a formulaic approach to risk assessment, e.g., “moderate” IR and “high” CR = “high”RMM.

When auditors read paragraph 34, I’m afraid that most of them will think through their formulas and try to figure out how to “plug” their CR assessment so that IR = RMM. This seems like an unproductive line of thought.

**Example language**

If the auditor does not plan to test the operating effectiveness of controls, then the assessment of the risk of material misstatement is the same as the assessment of inherent risk.
Concluding Remarks

I appreciate the effort required to create a document of this scope and quality. I am confident it will make a difference for the profession, and we look forward to incorporating the many insights contained in the proposed standard into our learning experiences.

Sincerely,

Michael Ramos, Managing Partner