November 25, 2020

Ms. Sherry Hazel
Audit and Attest Standards
American Institute of Certified Public Accountants
1345 Avenue of the Americas
New York, NY 10036-8775

RE: Proposed Statement on Auditing Standards, Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement

Dear Ms. Hazel:

We appreciate the opportunity to comment on the Proposed Statement on Auditing Standards, Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement (the “proposed SAS”). We support the Auditing Standards Board’s (ASB) objective of convergence with the International Auditing and Assurance Standards Board (IAASB)’s revised ISA 315, Identifying and Assessing the Risks of Material Misstatement. As the proposed SAS will impact audits of entities with a wide range of sizes, complexities, and circumstances, we appreciate the ASB’s efforts to embed concepts related to scalability within the proposed SAS.

We also appreciate the ASB’s efforts to improve audit quality by strengthening how auditors understand the entity and its system of internal control, and promoting a more robust identification and assessment of the risks of material misstatement. To this end, we encourage ongoing coordination with the AICPA Peer Review Board to determine whether other actions may be necessary to complement the proposed SAS in order to further promote high-quality risk assessments and address audit deficiencies noted in peer review.

We appreciate the principle in the proposed SAS that the auditor’s risk identification and assessment is iterative and dynamic. The explanatory memorandum explains that firms may have different approaches in their methodologies regarding the order in which the risks of material misstatement, and the significant classes of transactions, account balances, and disclosures and relevant assertions to which they relate, are identified. As risk assessment is not a linear process, it is important that the proposed SAS not be perceived as prescribing a particular approach or order to the auditor’s risk assessment process, as the process may depend on the nature and size of the entity, including whether it is a group audit.

In determining what revisions to AU-C section 315 are necessary in the context of the US environment, we believe it would also be helpful for the ASB to consider the PCAOB’s AS 2110, Identifying and Assessing the Risks of Material Misstatement. We support changes that have been made in the proposed SAS to define “significant classes of transactions, account balances, and disclosures” and “relevant assertions” similar to definitions in PCAOB standards, as many auditors are already familiar with these concepts. However, in certain areas of the proposed standard, we are concerned that terminology that differs from PCAOB standards could lead to confusion in practice and potentially inconsistent application. We draw attention to these areas in response to specific questions in the appendix.

Finally, we encourage the ASB to consider whether additional clarity is needed about the nature and extent of documentation expected to meet the requirements of the standard and whether additional
guidance is necessary to promote consistent application of both performance and documentation requirements (e.g., in various Accounting and Audit Guides).

The appendix contains our views on the specific issues set out in the explanatory memorandum, as well as our views on other matters we believe are relevant for the ASB to consider.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions you may have. Please contact Heidi Schuetze (heidi.i.schuetze@pwc.com) or Kathleen Healy (kathleen.k.healy@pwc.com) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP
Appendix

Request for Comment 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?

Generally, yes. We believe the requirements and application material of the proposed SAS are sufficiently scalable such that they can be applied to audits of entities with a wide range of sizes, complexities, and circumstances.

We are concerned, however, that there may be unintended consequences due to a lack of clarity in the requirement in paragraph 38 addressing documentation. See our response to Request for Comment 11.

Request for Comment 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:

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

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

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

Overall feedback on the proposals related to understanding of each of the components of the entity’s system of internal control (question 2(a))

We support the ASB’s view that understanding certain aspects of the entity’s system of internal control is integral to the auditor’s identification and assessment of the risks of material misstatement, regardless of the auditor’s planned controls reliance strategy. This message should be reinforced in training and education when the proposed SAS is finalized.

We generally support how the requirements in extant AU-C section 315 have been clarified in the proposed SAS, in particular how the understanding of the entity’s system of internal control is necessary to support a robust identification and assessment of the risks of material misstatement. See the discussion of controls that address the risks of material misstatement (control activities) below for further feedback.

We also believe the concept of scalability has been appropriately addressed in this area. We agree with the ASB’s view that the nature, timing, and extent of risk assessment procedures that the auditor performs to obtain the required understanding are matters of the auditor’s professional judgment, and serve as a basis for the identification and assessment of the risks of material misstatement. For example, auditors may take different approaches in complying with the proposed requirement in paragraph 25(a)(1) to
understand how information flows through the entity’s information system, depending on the level of sophistication of the information system. In some cases, this may be relatively straightforward, while in other cases specialized skills or knowledge may be necessary.

Controls that address the risks of material misstatement (control activities) (question 2(b))

The proposed SAS is intended to more clearly articulate what had previously been referred to as “controls relevant to the audit,” for which an understanding of design and implementation is required. This is consistent with PCAOB AS 2110, which notes that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented. However, we believe the proposed SAS should more explicitly acknowledge that, as the auditor obtains an understanding of other components of the system of internal control, the auditor is also likely to obtain knowledge about some control activities. Doing so would make the proposed SAS more consistent with paragraph 34 of PCAOB AS 2110.

We agree it is always necessary for the auditor to understand and evaluate design and implementation of the specific controls addressed in the requirements in paragraph 26(a)(i)-(iii). We also find the guidance in Appendix C and paragraph A181 to be helpful prompts of other areas to consider. However, we believe additional enhancements would promote greater consistency in the auditor’s determination of whether there are other controls that address risks of material misstatement at the assertion level whose design and implementation the auditor should understand. We believe the proposed standard should provide:

- more explicit focus in the requirement in paragraph 26 on information-processing controls.
- additional guidance to support the requirement in paragraph 26(iv) to remind auditors of the need to consider the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess inherent risk factors at the assertion level in accordance with paragraph 31, and

We suggest the following edits to address the above suggestions:

26. The auditor should, through performing risk assessment procedures, obtain an understanding of the control activities component by:

(a) identifying controls, including information-processing controls, that address risks of material misstatement at the assertion level in the control activities component as follows:

...  

(iv) Other controls that, based on the auditor’s professional judgment, the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level, based on the auditor’s professional judgment.

A162. As the auditor obtains an understanding of the other components of internal control, the auditor is also likely to obtain knowledge about some control activities. The control activities component includes controls that are designed to ensure the proper application of policies (which are also controls) in all the other components of the entity’s system of internal control and includes direct and indirect controls. For example, the controls that an entity has to ensure that its personnel are properly counting and recording the annual
physical inventory relate directly to the risks of material misstatement relevant to the existence and completeness assertions for the inventory account balance.

...

A181. In addition to the controls set out in paragraphs 26(a)(i)-(iii), other controls that the auditor may consider it appropriate to identify and evaluate the design and determine the implementation of other controls. This is because the auditor is required in accordance with paragraph 13 to have an appropriate basis for the identification and assessment of risks of material misstatement at the assertion level. Understanding additional controls can assist the auditor in assessing inherent risk, including taking into account how, and the degree to which inherent risk factors affect the susceptibility of relevant assertions to misstatement (see paragraph 31). Such controls may include some or all of the following:

- Controls that address risks assessed as higher on the spectrum of inherent risk but have not been determined to be a significant risk
- Controls related to reconciling detailed records to the general ledger
- Controls related to accounting estimates
- Complementary user entity controls, if using a service organization.

Consistency of terminology with COSO (question 2(c))

The terminology in paragraphs 21-27 is broadly consistent with that of COSO’s 2013 Internal Control-Integrated Framework (COSO framework). We understand that the ASB’s goal was to be consistent with ISA; however, it is important for auditors to understand how the proposed SAS is to be applied when the entity follows the COSO framework. Paragraph A102 acknowledges that entities may use different terminology or frameworks to describe the various aspects of the system of internal control. However, we believe additional application material or implementation guidance would be helpful to explain the interaction between terms described in the proposed SAS, such as information-processing controls and information system controls relevant to financial reporting, and well-understood terminology used in the COSO framework, such as application controls, automated controls, manual controls, technology general controls, and transaction controls. Doing so would encourage consistency in implementation of the proposed SAS.

We also believe further clarity should be added to explain the additional language in the definition of controls. The definition notes that policies may be documented, explicitly stated in communications, or implied through actions and decisions. We agree controls may be less formalized in some entities and believe it may be helpful to provide implementation guidance to demonstrate how the auditor would evaluate the design and implementation of controls that are implied through actions and decisions in accordance with paragraph 26.

Request for Comment 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?
We support the increased focus on 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, including new Appendix E. We believe it is important for the auditor to consider the effects of the entity’s use of IT on the identification and assessment of the risks of material misstatement.

We agree with the objective outlined in the explanatory memorandum that the auditor should focus on IT applications and other aspects of the IT environment determined to be subject to risks arising from the entity’s use of IT, and that the auditor’s procedures with respect to the entity’s IT applications may be more limited in certain circumstances. This is consistent with PCAOB AS 2110, which notes that, in obtaining an understanding of the entity’s control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. However, we do not believe the requirement in paragraph 26(b) is sufficiently clear, which could have unintended consequences. In an audit of a less complex entity, if there are no significant risks and the auditor does not plan to test the operating effectiveness of controls, we believe there is a risk that the auditor could potentially determine that there are no IT applications that are subject to risks arising from the use of IT, since the requirement in paragraph 26(b) is only applicable based on the controls identified in paragraph 26(a). As a result, the auditor may not evaluate the design and implementation of any general IT controls. It is unclear whether this was the ASB’s intent in drafting the requirements.

Request for Comment 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 of the definitions of significant classes of transactions, account balances, and disclosures and their relevant assertions and believe the related guidance is sufficient. We believe this will have a positive effect on audit quality in the public interest, as auditors hone their risk assessments to be more specific about which assertions related to classes of transactions, balances, and disclosures are relevant. These concepts are similar to those in PCAOB AS 2110, which we believe are well understood in practice.

Request for Comment 5 – Do you support the introduction of the spectrum of inherent risk into the proposed SAS? and Request for Comment 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?

Yes, we broadly support the introduction of the spectrum of inherent risk into the proposed SAS, as well as the concept of inherent risk factors. These are similar to risk factors articulated in PCAOB AS 2110, which are used in identifying significant accounts and disclosures and their relevant assertions. While we do not believe it is necessary to incorporate the concept of likely sources of potential misstatements from PCAOB standards into the proposed SAS, requiring auditors to take into account how inherent risk factors affect the susceptibility of relevant assertions to misstatement could result in a more robust consideration of what is driving the risk of material misstatement and therefore a more appropriate and tailored response.

We caution, however, that making the concept of a spectrum of inherent risk more explicit in the proposed SAS should not be viewed as driving specific documentation requirements about where on the spectrum
an assessed risk of material misstatement falls. Similarly, while we generally support the revised definition of significant risk and related application material, it is important to recognize that the determination of whether a risk is a significant risk is a matter of professional judgment. There may be unintended consequences in applying the definition if the phrase “close to the upper end of the spectrum of inherent risk” is interpreted to mean that there must be a ranking of risks and an assumption that every engagement must have a significant risk (other than those presumed in the AU-Cs).

Importantly, different audit firms may utilize different methodologies to operationalize the concept of a spectrum of risk and identify and assess inherent risks. For example, some firms may use different categories of risks to differentiate significant risks from other levels of risk while others may assign a rating on a scale. Additional implementation guidance may be helpful to illustrate the different ways in which the auditor’s identification and assessment of risks of material misstatement may be documented.

Request for Comment 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. Consistent with SAS 143, we believe it is appropriate for the proposed SAS to require that inherent risk be determined separate from control risk.

Request for Comment 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?

We agree with the sentiment in paragraph 34 that, when the auditor does not test the operating effectiveness of controls, that the risk of material misstatement is the same as the assessment of inherent risk. This is consistent with language in SAS 143, which addresses assessing control risk related to accounting estimates.

We support the discussion in paragraph A249 of the proposed SAS that the auditor’s assessment of control risk may be performed in different ways, depending on preferred audit techniques or methodologies. We suggest adding the following additional language to this paragraph to align with paragraph A71 of SAS 143.

The auditor’s assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, or minimum) or in terms of the auditor’s expectation of how effective the controls are in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

Request for Comment 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)?

We believe it is appropriate for the auditor to evaluate the design and implementation of the controls outlined in paragraph 26(a)(i)-(iii), including controls over journal entries, as well as other controls or
control activities that could have a significant impact on the auditor’s risk assessment and substantive response. We support the examples included in paragraph A181 of the proposed SAS.

Request for Comment 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 support the proposed stand-back requirement as a means of ensuring that material classes of transactions, account balances, and disclosures are appropriately considered in the auditor’s risk assessment. It is important that auditors consider both quantitative and qualitative materiality characteristics in determining significant classes of transactions, account balances, and disclosures, but materiality alone should not drive the auditor’s risk assessment and response.

For this reason, we support the focus in paragraph 18 of AU-C section 330 on performing substantive procedures for each relevant assertion of each significant class of transactions, account balance, and disclosure, regardless of the assessed level of control risk. Notwithstanding this, we believe that as the ASB and other standard setters continue to monitor the use of automated tools and techniques, there will likely be a need to revisit whether this requirement is meaningful if persuasive evidence can be obtained from performing procedures using automated tools and techniques such as audit data analytics, which may not be viewed as meeting the definition of substantive procedures.

Finally, we encourage the ASB to clarify the nature and extent of documentation that would be needed in relation to the stand-back.

Request for Comment 11 – What are your views with respect to the clarity and appropriateness of the documentation requirements?

We are concerned that the nature and extent of expected documentation is unclear. The proposed SAS notes that, in less complex entities, policies and procedures, and other elements of the system of internal control, may be less formalized, including with respect to elements of the control environment and the entity’s process for monitoring the system of internal control. In such cases, we would expect the auditor’s documentation of the key elements of the auditor’s understanding of the components of the entity’s system of internal control to potentially be brief. It would be helpful for the ASB and the Peer Review Board to discuss what may be expected with regard to documentation and provide additional implementation guidance to assist practitioners in understanding the scalability of the requirement in paragraph 28.

More broadly, paragraph 33(c) of extant AU-C section 315 requires the auditor to document identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level. The proposed SAS clarifies that, in doing so, the auditor is required to document the rationale for the significant judgments made.

The intent appears to align the requirements in the proposed SAS with the requirements in AU-C section 230 (as indicated in the footnote reference to paragraph 38 and the application material in paragraph A262), which we support. We agree with the language in the proposed SAS that notes that more detailed documentation is needed to enable an understanding of matters “not otherwise readily determinable from the documentation of the work performed of audit evidence obtained” and that “the form and extent of the auditor’s documentation is influenced by the nature, size, and complexity of the entity and its system of internal control, availability of information from the entity, and the audit methodology and technology used in the course of the audit.”
We also appreciate the explicit acknowledgment that “the auditor is not required to document every inherent risk factor that was taken into account in identifying and assessing the risks of material misstatement at the assertion level.” We believe this should apply to audits of all entities, not just less complex ones. If the concept of documentation of inherent risk factors is misunderstood in practice, there is a possibility that auditors may be driven towards a significant amount of additional documentation without incremental benefit. We encourage the ASB to monitor whether the IAASB develops specific guidance on documentation, as indicated in the IAASB’s *Basis for Conclusions*.

**Effective date**

We support the ASB’s view that the proposed SAS should be effective for audits of financial statements for periods ending on or after December 15, 2023. We believe the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit*, will need to be updated in advance of the effective date, as it provides helpful implementation guidance.