November 19, 2020

Via Electronic Mail

American Institute of Certified Public Accountants
1211 Avenue of the Americas, 19th Floor
New York, NY 10036-8775

RE: Response to AICPA Exposure Draft – Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement

The Office of the Washington State Auditor appreciates the opportunity to give input on the Auditing Standards Board’s (Board) proposed standard referenced above. In our constitutional role as the auditor of public accounts for the state of Washington, our Office annually performs or reviews over 800 financial audits of the State, its agencies, and all types of local governments. Our responses to the questions asked by the Board are included below.

Issues for Consideration:

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.

   We do not have any concerns about the scalability of the standards.

2.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?

   We do not have any concerns about this section.

2.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 address the risk of material misstatement are identified, particularly for audits of smaller and less complex entities?
We think it would be clearer to directly state in paragraph 26.a that the auditor should identify controls that address relevant assertions for significant classes of transactions, account balances and disclosures. In particular, we found the proposed requirement of 26.a.iv to be somewhat unclear.

We also found that separating paragraphs 26.b and 26.c made the requirements and related application material more difficult to follow, and would therefore suggest these be combined. We would further suggest that the auditor’s understanding of the IT environment and general IT controls that address such risks be clearly linked to the proper functioning of the controls identified in paragraph 26.a. We think it would be clearer to directly state that the auditor’s understanding of controls identified in paragraph 26.a includes identifying the IT applications and other relevant aspects of the entity’s IT environment, including any general IT controls, that are required for the proper functioning of the control to address the risk.

2.c. Given that the 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?

We find the terminology to be clear and capable of consistent interpretation for the entities we audit.

As an auditor of state and local governments, our entities most often use the GAO’s 2014 Standards for Internal Control in the Federal Government (“Green Book”). The Green Book is based on COSO and uses the same five elements, but it would be helpful if the application material referenced both COSO and the Green Book.

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. In particular, we agree with the Board’s view that it is not necessary for the auditor to identify risks arising from use of IT or general IT controls, unless they are determined to be relevant. We think this view could be made clearer as described in our response to question 2.b.

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 strongly support the new concepts and related definitions, and found the guidance to be clear and helpful.

The only aspect that remains unclear is the role of risk assessment procedures that may provide direct indications of the potential for misstatement, such as analytical procedures. Analytical procedures are clearly for risk assessment purposes, and are not a control risk factor, yet they are not included in the list of inherent risk factors.

We would therefore suggest the Board expand the inherent risk factors in Appendix B to include factors identified by analytical procedures and other risk assessment procedures that may provide direct indications of the potential for misstatement. In this way, the guidance would clearly show why the information is obtained and how it is used in the risk assessment process. Specifically, we would suggest the following additional inherent risk factors:

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<th>Change</th>
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<td><strong>Abnormality</strong></td>
<td>• Reported or omitted balances, classes of transactions or disclosures that are unusual or unexpected for the entity’s industry</td>
<td>• Reported amounts or disclosures that are significantly different than in previous years</td>
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<td>• Reported or omitted balances, classes of transactions or disclosures that are unusual or unexpected given the events, conditions or activities of the entity during the period</td>
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<td>• Financial statement relationships that appear to be conflicting, unusual or unexpected</td>
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<td>• Reported or omitted amounts or disclosures that appear to conflict with other information obtained by the auditor as part of risk assessment procedures</td>
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<td><strong>Susceptibility to misstatement as identified by past experience, management, or others</strong></td>
<td>• Past misstatements, a history of errors, or a significant amount of adjustments at period end</td>
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<td>• Identification by the entity (for example, as part of the entity’s risk assessment process or during inquiries with entity management) as being high risk or difficult to determine</td>
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<td>• Concerns raised by whistleblowers or outside parties regarding potential misstatements</td>
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At question is how information obtained by the auditor as part of required risk assessment procedures – including inquiry, observation, analytical procedures, consideration of prior audit results, review of governing body minutes, etc. – is factored into the auditor’s conclusions regarding the reasonable possibility of misstatement.
5. **Do you support the introduction of the spectrum of inherent risk?**

We agree that inherent risk exists on a spectrum. However, we feel the definition of inherent risk is sufficient and there is no need for a separate “spectrum” concept. Inherent risk is no different than control risk or the risk of material misstatement (or any other risk) in that it has relative degrees of likelihood and magnitude. To separately identify the concept that inherent risk has relative degrees begs the question of why there are no separate concepts to describe this attribute of all other risks included in the standards. The reason, of course, is that risks are already understood to exist on a spectrum and that separately defining such a concept is unnecessary.

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

We support the separate assessments of inherent and control risk. We view the requirements as being a more clear expression of the extant standard.

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 view the requirements as being a clearer expression of the extant standard.

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?**

We view the requirements of this paragraph as being a clearer expression of the extant standard.

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 support the revised definition and related material.

However, as we described in our response to question 4, clarification is needed as to whether results of analytical procedures and other risk assessment procedures that provide direct indications of misstatements would be considered inherent risk factors. In our experience, significant risks are often identified in part or in whole due to analytical procedures, review of governing body minutes, review of news articles, correspondence with regulatory or oversight bodies and other similar procedures that are not currently included as inherent risk factors in Appendix B.
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?**

Proposed changes to paragraph 18 of AU-C 330 are entirely clear and appropriately resolve the confusion with extant language.

However, in our view, the “stand back” requirement in paragraph 36 of the proposed SAS is both confusing and unnecessary. It is confusing because the definition of “material” requires essentially the same determination as for “significant.” Paragraph A256 defines a “material” class of transactions, account balance or disclosure as one where “there is a substantial likelihood that omitting, misstating, or obscuring information about them would influence the judgment made by a reasonable user.” We would argue that all classes of transactions, account balances or disclosures could have a substantial likelihood of influencing the judgment of a reasonable user if misstated, since accounting standard setters only require information that is decision-useful. Therefore, a determination cannot be made that a required financial statement element is not “material” without consideration of the likelihood and magnitude of potential misstatements for a specific entity in its environment. And the only basis to determine such a potential for misstatement is the auditor’s risk assessment procedures and assessment of inherent risk factors – which is one-in-the-same with the determination of significant classes of transactions, account balances or disclosures.

It is unnecessary because the auditor is already required to “stand back” and evaluate the sufficiency and appropriateness of work efforts at multiple points in the audit. For example, paragraph 35 already requires the auditor to “stand back” and evaluate whether audit evidence from risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement. If the Board intends for auditors to specifically consider whether risk assessment information was sufficient for elements reported at quantitatively large amounts, then the Board should say so directly in the application material for paragraph 35.

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

We do not have any concerns with this section.

**Other Comments – Early Implementation Option:**

On the whole, the proposed standard appears to be mainly clarification or clearer description of existing requirements rather than a substantial change to requirements. We would therefore suggest the Board allow for early implementation of the revised standard.
An option for early implementation can allow audit organizations to implement quality control materials and training more efficiently and effectively. For example, some audit organizations may have natural breaks in workload that correspond to different fiscal year ends (such as June or August). Also, some audit organizations may have work on certain December fiscal year-end audits overlap with work on certain other audits with earlier fiscal year ends. In such cases, new standards would need to be used in parallel with the old standards, increasing complexity for auditors and the risk of using an incorrect standard in their audit.

Thank you for the opportunity to provide our comments. Any inquiries may be directed to me at (564) 999-8014.

Sincerely,

Scott Woelfle, CPA
Director for Quality Assurance and Innovation