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# EXPOSURE DRAFT

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## PROPOSED STATEMENT ON AUDITING STANDARDS

### *UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT*

*(Supersedes Statement on Auditing Standards [SAS] No. 122, Statements on Auditing Standards: Clarification and Recodification, as amended, 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement [AICPA, Professional Standards, AU-C sec. 500]; Amends various other sections in SAS No. 122, as amended [AICPA, Professional Standards, AU-C secs. 200, 240, 330, 540, 930, 935, and 940])*

**August \_\_, 2020**

**Comments are requested by November \_\_, 2020**

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

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## CONTENTS

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|   | Page |
|---|------|
| <b>Explanatory Memorandum</b>   |      |
| Introduction .....  | 4    |
| Background.....   | 4    |
| Convergence .....   | 4    |
| Effective Date .....  | 5    |
| Fundamental Aspects of the Proposed SAS.....  | 5    |
| Guide for Respondents.....  | 19   |
| Comment Period .....  | 19   |
| Auditing Standards Board.....   | 20   |
| <br><b>Exposure Draft</b>   |      |
| Proposed Statement on Auditing Standards <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i> ..... | 21   |

# Explanatory Memorandum

## Introduction

This memorandum provides background to the proposed Statement on Auditing Standards (SAS) *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. If issued as final, this proposed SAS will supersede SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AU-C section 315).<sup>1</sup>

## Background

SAS No. 122 was issued by the Auditing Standards Board (ASB) in October 2011 to apply the clarity drafting conventions to all outstanding SASs issued by the ASB through SAS No. 121, including AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

The AICPA's Enhancing Audit Quality Initiative identified the auditor's risk assessment as an area of focus in 2019, in part because deficiencies in the process of obtaining the required understanding of internal control is a common audit issue identified by practice monitoring programs worldwide.

This project to enhance the auditing standards relating to the auditor's risk assessment was intended to enable auditors to appropriately address:

- a. Understanding the entity's system of internal control, in particular relating to the auditor's work effort to obtain the necessary understanding.
- b. Modernizing the standard in relation to information technology (IT) considerations, including addressing risks arising from IT.
- c. Determining significant risks.

The AICPA's Auditing Standards Board (ASB) has monitored developments related to the auditor's risk assessment. In particular, the ASB followed the project of the International Auditing and Assurance Standards Board (IAASB) to revise ISA 315, *Identifying and Assessing the Risks of Material Misstatement* (ISA 315 Revised). ISA 315 (Revised) is effective for audits of financial statements for periods beginning on or after December 15, 2021. The ASB Risk Assessment Task Force was formed to consider the implications of this project when identifying assessing the risks of material misstatements for audits of nonissuers.

## Convergence

The ASB has a strategy to converge its standards with those of the IAASB. In doing that, the ASB uses the corresponding ISA as the base in developing its standards. In making the proposed

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.

revisions to the accompanying proposed SAS, the ASB used ISA 315 (Revised) as the base. The ASB has made certain changes to the language in ISA 315 (Revised) to use terms or phrases that are more common in the United States and to tailor examples and guidance to the U.S. environment.

## **Effective Date**

If issued as final, the proposed SAS will be effective for audits of financial statements for periods ending on or after December 15, 2023.

## **Fundamental Aspects of the Proposed SAS**

### ***I. Public Interest Issues Addressed in the Proposed SAS***

Although all the proposed revisions in this exposure draft are made with the public interest in the forefront, revisions that are most important in supporting the public interest are set out below.

A proper identification and assessment of the risks of material misstatement drives the performance of a quality audit because a proper risk assessment is the basis on which the auditor plans and performs audit procedures and gathers audit evidence to support the audit opinion on the financial statements.

The proposed SAS builds on the foundational concepts relating to an audit of financial statements in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, (such as audit risk, identifying risks at the financial statement and assertion levels, and the definitions of inherent risk and control risk). In undertaking the revision of extant AU-C section 315, the ASB did not seek to fundamentally change the key concepts underpinning audit risk as the ASB continues to have the view that the audit risk model is fundamentally sound. Rather, the ASB focused on how certain aspects of the identification and assessment of the risks of material misstatement can be clarified and improved in order to drive better risk assessments and therefore enhance audit quality.

#### *Scalability*

In proposing revisions to the proposed SAS, the ASB recognizes that the auditor's ability to serve the public interest includes the ability to apply the standard to the audits of financial statements for all entities, ranging from non-complex entities to complex multinational entities.

The ASB is of the view that although size of the entity matters, the level of complexity in the nature of an entity and its financial reporting is the primary driver of scalability in the application of the proposed SAS. Many smaller entities have complexities in their business model and their financial reporting processes and therefore auditors may be required to perform more detailed risk assessments.

The ASB agreed to include in the application material considerations for audits of entities that are less complex, which are those audits that would typically require simpler risk assessment procedures. Some of these considerations are contrasted with considerations for audits of more

complex entities (for example, in relation to the understanding of an entity’s use of IT). This approach is intended to demonstrate scalability in both directions, in relation to the nature, timing, and extent of the auditor’s risk assessment procedures.

The ASB recognizes that the considerations for audits of less complex entities may be relevant to audits of large entities that have simple business models or financial reporting processes and for which the auditor’s risk assessment may be simpler than it would be for a more complex entity. Therefore, paragraph 9 of the proposed SAS notes that some of the considerations for entities that are less complex may be applicable in audits of large but less complex entities.

In making the proposed revisions with regard to scalability, the ASB has removed the extant “considerations specific to smaller entities” sections throughout the proposed SAS. However, most of the matters previously included in these sections have been retained and incorporated into the text of the application material of the proposed SAS as appropriate, together with further proposed revisions to promote scalability. In some cases, the content of the extant “considerations specific to smaller entities” sections is not unique to audits of smaller and less complex entities. The ASB has also considered the placement of guidance related to scalability, in many cases, placing guidance relating to audits of smaller and less complex entities at the start of the relevant sections, so that auditors of such entities are able to more appropriately consider the material that follows in context.

#### **Request for Comment**

1. Are the requirements and application material of the proposed SAS sufficiently scalable, including the ability to apply the proposed SAS to the audits of entities with a wide range of sizes, complexities and circumstances?

#### *Modernizing and Updating AU-C 315 for an Evolving Business Environment*

Significant changes in, and the evolution and increasingly complex nature of, the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate, and recent developments relating to internal control and other relevant frameworks, have necessitated proposed revisions to extant AU-C section 315.

#### *Automated Tools and Techniques*

Auditors increasingly use automated tools and techniques (including audit data analytics) when performing risk assessment procedures. The ASB acknowledges the importance of explicitly recognizing the usage of such tools and techniques, but also understands the need to not require the use of specific tools and techniques, and which might, in the judgment of the auditor, not be necessary or appropriate in the circumstances.

#### *Information Technology*

As IT is a medium through which a significant amount of audit evidence is obtained, it is important for auditors to understand an entity’s IT environment with particular focus on those aspects that are relevant to financial reporting, including how the integrity of the information is maintained.

As part of the modernization of the standard, the ASB recognized that changes and enhancements were needed with regard to an entity's use of IT. Accordingly, the ASB has proposed significant clarifications and enhancements to the requirements in the proposed SAS such that the auditor is required to understand certain aspects of the entity's use of IT in its business and system of internal control. This understanding forms the basis for the auditor's identification of risks of material misstatement arising from the entity's use of IT and the identification of relevant general IT controls that the entity has put in place to address those risks of material misstatement.

### *Fostering Independence of Mind and Professional Skepticism*

The ASB recognizes the central role that professional skepticism plays in an audit. The proposed SAS contains several key provisions that are designed to enhance the auditor's exercise of professional skepticism, including:

- Emphasizing the importance of exercising professional skepticism in the introductory paragraphs.
- Clarifying that an appropriate understanding of the entity and its environment, and the applicable financial reporting framework, provides a foundation for being able to exercise professional skepticism throughout the rest of the audit.
- Highlighting the benefits of exercising professional skepticism during the required engagement team discussion.
- Highlighting that contradictory evidence may be obtained as part of the auditor's risk assessment procedures.

In addition, the IAASB has explained that the purpose of performing risk assessment procedures is to obtain sufficient appropriate audit evidence as the basis for the identification and assessment of the risks of material misstatement.

### *The Auditor's Considerations Relating to Fraud*

The proposed SAS contains a number of other proposed changes intended to further the public interest, including the introduction of the inherent risk factors (described further below). As part of the guidance related to inherent risk factors, which is intended to assist with the identification and assessment of the susceptibility of assertions to misstatement, a link has been made to the auditor's consideration of susceptibility of misstatement due to fraud. The ASB has further considered whether more enhancements need to be made in the proposed SAS in relation to the auditor's consideration of the risks of fraud. On balance the ASB believes that there are sufficient references within the proposed SAS to AU-C section 240 but has highlighted in paragraph 6 of the proposed SAS the need to also apply AU-C section 240 when identifying and assessing the risks of material misstatement due to fraud.

## **II. *Understanding the Entity and Its Environment***

## *Focusing on the Applicable Financial Reporting Framework in Identifying Risks of Material Misstatement*

The ASB has restructured the requirement that focuses on the auditor's understanding of the entity and its environment and has elevated the importance of the auditor's required understanding of the applicable financial reporting framework, because it is the application of the framework in the context of the nature and circumstances of the entity that gives rise to potential risks of misstatement. This revision is intended to clarify the context of the understanding of the applicable financial reporting framework and includes enhancements requiring the auditor to focus on the reasons for changes to the entity's accounting policies. The concept of *inherent risk factors* is also discussed as the auditor contemplates potential risks arising from the application of the applicable financial reporting framework (the concept of *inherent risk factors* is further described below).

### **III. *Understanding the Entity's System of Internal Control***

In inspection findings and outreach, significant concerns have been highlighted relating to obtaining an understanding of the entity's system of internal control. In particular, it was noted that it was not always clear:

- Why the understanding is required to be obtained (for example, when a primarily substantive approach to the audit is planned) and how the information obtained is to be used;
- What procedures are required in order to "obtain the necessary understanding" for certain components of internal control;
- Whether all components of internal control as set out in the standard need to be understood; and
- When controls are considered "relevant to the audit."

In addition, it was noted that it can be confusing when inconsistent terminology is used when describing concepts such as "internal control" and "controls."

The ASB believes 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. In particular, the understanding informs the auditor's expectations about the operating effectiveness of controls and therefore is the foundation for the auditor's assessment of control risk. It is important to be clear about the work effort necessary in obtaining the required understanding, and the ASB has proposed revisions, as explained below, in this regard.

The proposed SAS also makes it clear that the overall requirement for understanding the entity's system of internal control is achieved through the requirements that address understanding each of the components of the system of internal control. The order in which the components are presented has also been changed as a result of the clarification described below related to the nature of each component, such that the three components that consist primarily of "indirect controls" are



presented separately from the two components that consist of primarily ‘direct controls’ (“indirect” and “direct” controls are described below).

### *Terms Used to Describe Aspects of the Entity’s System of Internal Control*

The ASB has considered the various terms used to describe an entity’s system of internal control or aspects thereof and has made amendments to the descriptions of terms used, as well as revisions throughout the proposed SAS to apply the revised terms consistently. These changes, made throughout the proposed standard, include the following:

- The term *internal control*, as it is used in extant AU-C section 315, has been changed to *system of internal control*, and the definition has been updated to reflect that it is comprised of five inter-related components.
- The use of the term *controls* has been clarified by including the following definition in the standard:

“Controls are...[p]olicies or procedures that are embedded within the components of the system of internal control to achieve the control objectives of management or those charged with governance. Within this context, policies are statements of what should, or should not, be done within the entity to effect internal control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions. Procedures are actions to implement policies.”

The ASB also agreed that “policies and procedures” should be considered in a broad context and may include aspects of governance (for example, tone at the top) and other aspects of the entity’s systems (such as the risk assessment process in some entities) which are established, but are not formally documented. Accordingly, proposed revisions have been made to the application material to recognize that some aspects of the entity’s system of internal control may be less formalized but still functioning. The ASB believes that this acknowledges that controls may also be less formalized, thereby contributing to the scalability of the required understanding, and the way it is interpreted within each of the components.

- Components of internal control for the purposes of the AU-Cs include the control environment, the entity’s risk assessment process, the entity’s process to monitor the system of internal control, the information system (including related business processes) and communication, and control activities. Within each of these components, individual controls are embedded (that is, each component is comprised of a collection of controls). The proposed revisions to the requirements for each component have specified the matters for which an understanding is required.
- “Control activities” refers to the component of the entity’s system of internal control that typically includes controls over the flows of information within the information system. The required understanding for this component is obtained through the auditor’s identification and understanding of certain controls that address risks of material misstatement (see the discussion below about controls that address the risks of material misstatement).

## *Understanding Internal Control through Understanding the Five Components of Internal Control*

The ASB continues to believe that the five components of internal control as described above, comprising the entity's system of internal control, remain an appropriate structure to describe the auditor's understanding of the system of internal control required to be obtained for the purposes of the AU-Cs. In its deliberations, the ASB agreed that the auditor needs to obtain an understanding of certain aspects of all of the components, specifically whether and how they have been addressed by the entity, and revised the requirements for each of the components to be clearer about the specific matters relating to that component that need to be understood.

In its deliberations about obtaining an understanding about the components of the system of internal control, the ASB agreed that differentiating the nature of each of the components would help the auditor recognize how the understanding provides the basis for the auditor's identification and assessment of the risks of material misstatement. In the view of the ASB, controls within the:

- “Control environment”, “entity's risk assessment process”, and “entity's process to monitor the system of internal control” components have controls that are typically more “indirect” in nature (that is, they are controls that generally do not directly address the risks of material misstatement at the assertion level). Such indirect controls are more likely to be relevant to the auditor's identification and assessment of risks of material misstatement at the financial statement level. For example, if the entity's control environment is not functioning as expected given the size and complexity of the entity, this could affect the opportunity for fraud to be committed, which may be identified as a financial statement level risk (that is, a risk that has a pervasive effect on the financial statements).
- “Information system and communication” and “control activities” components are comprised of controls that are more likely to directly address the risks of material misstatement at the assertion level (“direct controls”). The design of the information system is established in the policies and procedures that define the nature, timing, and extent of the entity's financial reporting processes and how the entity's personnel, IT, and other resources are deployed in applying them. Such controls are referred to as “information system controls relevant to financial reporting.” The auditor is required to evaluate the design of certain information system controls relevant to financial reporting (as listed in the standard) and determine whether they have been implemented, and this evaluation will assist the auditor in identifying risks of material misstatement at the assertion level. Controls in the control activities component are controls over the flows of information and the financial reporting processes within the entity's information system. (See Controls that Address the Risks of Material Misstatement section below).

## *Work Effort for Understanding Each of the Components of Internal Control*

Clarifying the requirements related to the understanding of each component of the system of internal control is an important aspect of the proposed enhancements to the standard. Within each component, the ASB has set out the matters that need to be understood and provided further guidance about the extent and scalability of procedures necessary to obtain that understanding. 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 are based on the

auditor's determination regarding the procedures that will provide sufficient appropriate audit evidence to serve as a basis for the identification and assessment of the risks of material misstatement.

### *Controls that Address the Risks of Material Misstatement*

To assist the auditor with identifying controls that address the risks of material misstatement, the related requirement has been clarified to create a list of the types of control activities that, if applicable, the ASB believes are always relevant to the risks of material misstatement. Recognizing that entities have a wide variety of circumstances, in addition to the specifically enumerated types of controls in this component, auditors are required to use professional judgment to determine if there are any other controls for which evaluation of their design and determination of whether they have been implemented are necessary to enable the auditor to identify and assess risks of material misstatement. It has also been clarified that controls that address the risks of material misstatement at the assertion level are primarily direct controls, residing in the control activities component. However, the auditor may identify certain controls that address the risks of material misstatement at the assertion level in other components of the system of internal control.

The Control Activities section of proposed SAS also includes enhanced requirements to identify general IT controls relevant to the audit. These enhanced requirements are discussed in the next section.

The auditor is required to evaluate the design of certain control activities that address the risks of material misstatement, including general IT controls, and determine whether they have been implemented (this is referred to as "D&I"). The related requirement and application material have been clarified and enhanced. In particular, new guidance has been included about the benefits of the auditor's D&I procedures for the design and performance of further audit procedures. The auditor's D&I procedures provides the basis for the auditor's assessment of control risk at the assertion level to be assessed at less than maximum. The auditor's assessment of the risks of material misstatement, which includes the assessment of control risks, assists the auditor in designing and performing further audit procedures.

Application material provides further details related to understanding and evaluating information system controls relevant to financial reporting and control activities that address the risks of material misstatement.

#### **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 or 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?

### *Enhanced Guidance Related to IT*

As IT is the medium through which a significant amount of audit evidence is obtained, it is important for auditors to understand certain aspects of an entity's IT system, including how the integrity of information relevant to the preparation of the financial statements is maintained.

The most significant proposed enhancements to the proposed SAS addressing the entity's use of IT are in the requirements for the information system and communication component and for the identification of certain controls that address the risks of material misstatement. In understanding the information system relevant to financial reporting, the auditor is required to understand the related IT environment in order to gain a high-level understanding of the nature and complexity of the environment and its supporting processes. Using the auditor's understanding of the information system and communication relevant to preparation of the financial statements, as well as the identification of certain controls that address the risks of material misstatement (see previous section), the auditor determines which IT applications and other aspects of the IT environment are subject to risks arising from the use of IT, as defined in the proposed SAS. This process helps the auditor identify IT applications for which risks arising from the entity's use of IT may exist, and that may affect the design, implementation or operating effectiveness of automated controls, or other controls over the integrity of information.

For the IT applications and other aspects of the IT environment determined to be subject to risks arising from the use of IT, the auditor identifies the risks arising from the entity's use of IT and identifies general IT controls that address those risks. The application material to these requirements has been enhanced to explain some possible risks and controls that the auditor may consider, and to explain that the extent to which general IT controls address the risks of material misstatement will vary, based on the circumstances of the engagement and planned audit approach or strategy. A new Appendix E has also been added to the proposed SAS to provide further considerations related to general IT controls.

The ASB believes that this approach will assist the auditor's decision-making in determining the extent of general IT controls that address the risks of material misstatement. In particular, the ASB is of the view that it is not necessary for the auditor to identify risks arising from the entity's use of IT or general IT controls, unless they relate to IT applications that are determined to be relevant for the auditor's purposes.

When an entity's IT environment consists only of commercial software for which the entity does not have access to the underlying source code such that no program changes can be made (which may be the case for many less complex entities), the auditor's procedures with respect to the entity's IT applications maybe more limited. In contrast, for more complex entities or for audits where the auditor plans to test the operating effectiveness of automated controls, the auditor may determine that there are several IT applications relevant to the audit. This may drive a greater

extent of general IT controls being identified as controls that address the risks of material misstatement.

#### **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 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?

#### *Other Matters Relevant to Understanding the Entity's System of Internal Control*

Deficiencies in internal control (including material weaknesses and significant deficiencies) are described and addressed in AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*. Extant AU-C section 315 contains an explicit requirement that the auditor consider whether deficiencies in internal control weaknesses were identified only in the context of the auditor's understanding of the entity's risk assessment process. The ASB has recognized that a deficiency in internal control may arise within any of the components of the entity's system of internal control and that these deficiencies may be identified when the auditor is obtaining an understanding of the system of internal control. As identified deficiencies in any components may have implications for the audit, including informing the auditor's identification of risks of material misstatement, as well as reporting requirements in terms of AU-C section 265, the ASB has added a linkage to AU-C section 265 for the auditor to determine, on the basis of the work performed under this proposed SAS (that is, for all the components of the system of internal control), whether control deficiencies have been identified and to evaluate the implications on the audit when such deficiencies have been identified (see paragraph 27 of the proposed SAS).

#### **IV. Identifying and Assessing the Risks of Material Misstatement**

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

The ASB has noted continuing concerns related to the implementation of the requirements for the identification and assessment of risks of material misstatement. In addition, the ASB has noted that inspection findings commonly refer to an apparent lack of consistency in the determination of significant risks.

To assist auditors in understanding the requirements related to the identification and assessment of risks of material misstatement, the ASB believes a clearer description of the required risk identification and assessment process will help drive a more consistent and focused approach, and thus improve audit quality through its impact on the design and performance of further audit procedures. To facilitate this, the ASB has introduced the following new concepts and definitions, and significantly enhanced the related requirements:

- **Inherent risk factors** (new definition)—characteristics that affect susceptibility to misstatement of an assertion about a class of transactions, account balance, or disclosure, and that may be quantitative or qualitative in nature. Such factors include complexity,

subjectivity, change, uncertainty, and susceptibility to misstatement due to management bias or fraud. Inherent risk factors are intended to assist the auditor in focusing on those aspects of events or conditions that affect an assertion's susceptibility to misstatement, which in turn facilitates a more focused identification of risks of material misstatement. Taking into account the degree to which the inherent risk factors affect susceptibility to misstatement assists in the assessment of inherent risk (see the explanation of "spectrum of inherent risk" below).

- Relevant assertions—have been revised to focus auditors on those assertions relevant to a class of transactions, account balance, or disclosure when the nature or circumstances are such that there is a reasonable possibility of occurrence of misstatement, with respect to an assertion, that is material, either individually or in combination with other misstatements. Application material to the definition explains that a relevant assertion is one for which one or more risks of material misstatement exist. The introduction of the concept of *relevant assertion* is expected to enhance the likelihood the auditor will identify risks of material misstatement by requiring the auditor to identify those assertions where risks of material misstatement exist (that is, are reasonably possible) and therefore need to be assessed so further audit procedures may be designed and performed.
- Significant class of transactions, account balance, or disclosure (new definition)—a class of transactions, account balance, or disclosure for which there is one or more relevant assertions. The introduction of the concept of a significant class of transactions, account balance, or disclosure is viewed by the ASB to have the benefit of clarifying the scope of the auditor's understanding of the information system, and for the auditor's identification and assessment of, and responses to, assessed risks of material misstatement, including the related requirements in the recently revised AU-C section 540 that address these topics in the context of auditing accounting estimates.
- Spectrum of inherent risk —a concept included in the introductory paragraphs (see paragraph 5 of the proposed SAS) and application material recognizing that inherent risk factors individually or in combination affect inherent risk to varying degrees and that inherent risk will be higher for some assertions than for others. The degree to which inherent risk varies is referred to as the spectrum of inherent risk. The relative degrees of the likelihood and magnitude of a possible misstatement determine where on the spectrum of inherent risk the risk of misstatement is assessed. The ASB is of the view that the introduction of the spectrum of inherent risk will facilitate greater consistency in the auditor's identification and assessment of risks of material misstatement by providing a frame of reference for the auditor's consideration of the likelihood and magnitude of possible misstatements and the influence of the inherent risk factors.

#### **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?

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

Questions have arisen in both the AU-C section 540 and AU-C section 315 projects about the “combined” assessment of inherent risk and control risk as permitted by extant AU-C section 200. Noting the requirements in paragraph 7 of AU-C section 330 that require the auditor to consider inherent risk and control risk separately in order to respond appropriately to assessed risks of material misstatement, the ASB agreed that a separate assessment of inherent risk and control risk should be required, and that this requirement would initially appear in SAS 143, *Auditing Accounting Estimates*.<sup>2</sup> The proposed SAS extends the requirement for the separate assessments of inherent and control risk in relation to all risks of material misstatement at the assertion level. New requirements have been included in the proposed SAS that address these separate assessments of inherent risk and control risk (see paragraphs 31 and 34 of the proposed SAS).

The ASB acknowledges that the order in which the requirements related to the identification of the risks of material misstatement are to be applied should not be prescribed. For example, 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 the relevant assertions to which they relate, are identified. The process is iterative and is likely to be applied differently in an initial audit engagement versus a recurring engagement. Regardless of an auditor’s methodology, each of the relevant requirements should be complied with, and that the auditor’s understanding of the system of internal control should be appropriate to enable the auditor to identify and assess risks of material misstatement sufficient to form a basis for the design and performance of further audit procedures. For example, the auditor is required to identify controls that address the risks of material misstatement based on the determination of significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence. As another example, the auditor forms an initial expectation of the significant classes of transactions, account balances, and disclosures when understanding the entity and its environment and the applicable financial reporting framework. The auditor uses this expectation in understanding the information system and communication, which may affect the auditor’s ultimate determination of the significant classes of transactions, account balances, and disclosures when identifying the risks of material misstatement.

The ASB has clarified the work performed on the D&I of certain controls that address the risks of material misstatement, by enhancing the application material to further explain how the D&I work interacts with the auditor’s identification of risks and assessment of control risk. The ASB has made it clear that if the auditor does not contemplate testing the operating effectiveness of controls, or is not required to test controls, control risk is assessed at maximum. This means that control risk cannot be reduced based on the effective operation of controls unless the auditor intends to test them. Although auditors who intend to perform a primarily substantive audit thus will not need to test the operating effectiveness of controls, work on the D&I of controls may affect the

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<sup>2</sup> SAS No. 143 was approved by the ASB in May 2020 and, when issued, will have an effective date of audits of financial statement for periods ending or after December 15, 2023.

identification and assessment of risks of material misstatement, and the nature and extent of substantive procedures to be performed.

In making these revisions, the ASB has focused on how clearer requirements will help auditors make more consistent and effective assessments of identified risks of material misstatement, thereby providing an enhanced basis for the design and performance of further audit procedures, as well as overall responses to risks of material misstatement at the financial statement level (as required by AU-C section 330).

#### **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?
7. What are your views with respect to 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?
8. What are your views with respect to the clarity of the requirement to evaluate design and determine implementation of certain control activities (including, specifically, the requirement related to controls over journal entries)?

#### *Relationship of Concepts with AU-C section 540*

The ASB has striven to closely coordinate the work between the AU-C section 315 and AU-C section 540 Task Forces in the development of proposed revisions to both standards. Some of the new concepts in the proposed SAS have already been approved in SAS No. 143 which amends AU-C section 540, including inherent risk factors, the spectrum of inherent risk, and the separate assessments of inherent risk and control risk. The ASB believes these concepts are appropriate for this proposed SAS because they are applicable to all types of classes of transactions, account balances, and disclosures, not just those involving accounting estimates. The ASB has also worked towards addressing the use of these concepts consistently between the standards, recognizing that references to these concepts in SAS No. 143 specifically relate to accounting estimates. Because the close interaction between the proposed SAS and SAS no. 143, the ASB is proposing the align the effective dates of the standards. Both standards would be effective for audits of financial statements for periods after on or after December 15, 2023.

#### *Significant Risks*

A key inspection finding related to a lack of consistency with which significant risks are determined. The ASB believes that one of the main reasons for this inconsistency lies in the definition of significant risk. The current definition focuses the auditor on the response to the risk rather than the nature of the risk. In extant AU-C section 315, significant risks are those that require “special audit consideration.”

In its deliberations, the ASB specifically considered the introduction of the spectrum of inherent risk and whether the spectrum alone might provide a framework sufficiently robust to properly assess all risks or whether the auditor should still be required to separately determine significant



risks. On balance, the ASB believed that it was important to retain the concept of, and requirement to determine, significant risks because of the focused work effort in other AU-Cs on these types of risks.

To promote a more consistent approach to determining significant risks, the ASB revised the definition to focus not on the response, but on those risks for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk. This revision to the definition also incorporates the extant requirement for significant risks to be determined excluding the effects of identified controls related to the risks (that is, based on inherent risk alone).

In revising the definition of significant risk, the ASB also deliberated whether these risks are represented on the spectrum of inherent risk by a higher likelihood of occurrence *and* a higher magnitude of potential misstatement should the risk occur, or whether a significant risk could also be present when there is a higher magnitude of potential misstatement but a lower likelihood of the risk occurring. On balance, the ASB agreed that there could be risks potentially lower in likelihood, but for which the magnitude could be very high if it occurred, and that it was probably not appropriate to explicitly exclude these risks from the auditor's determination of significant risks. The definition therefore acknowledges that the determination of whether a risk is a significant risk requires the application of professional judgment.

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| <p>9. Do you support the revised definition, and related material, on the determination of significant risks? What are your views on the matters presented above relating to how significant risks are determined based on the spectrum of inherent risk?</p> |
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#### *Identified and Assessed Risks of Material Misstatement at the Financial Statement Level*

Extant AU-C section 315 requires identification and assessment of the risks of material misstatement at the financial statement level but does not prescribe how to do this or specify how this interacts with the identification and assessment of the risks of material misstatement at the assertion level. The ASB considered the nature of risks of material misstatement at the financial statement level, reflecting on how they are described in AU-C section 200, in order to better describe and address them in the proposed SAS.

Under AU-C section 200, every identified risk of material misstatement relates either specifically to an individual assertion or to a number of assertions, which could be in one or more classes of transactions, account balances, or disclosures. However, when the risk relates to a number of assertions (that is, is more pervasive), the risk is considered to exist at the financial statement level. The assessment of risks of material misstatement at the financial statement level involves determining the effect of such risks on the assessment of risks of material misstatement at the assertion level. Because of the pervasive nature of the risks at the financial statement level, it may be difficult however to identify specific assertions that are affected (for example, fraud risks such as risk of management override of controls). For that reason, assessment of risks at the financial statement level also involves evaluating the nature and extent of their pervasive effect on the financial statements to provide the basis for designing and implementing overall responses to the risks. Proposed revisions have been made to the requirements and application material to better reflect the relationship of these risks to the risks of material misstatement at the assertion level.

The ASB is also of the view that risks at the financial statement level will often arise from deficiencies in the components of the entity’s system of internal control that consist primarily of “indirect controls,” in particular the control environment, which will likely have a more pervasive effect on a number of, or all, classes of transactions, account balances, and disclosures, in the financial statements. Accordingly, the application material has been enhanced to link the auditor’s understanding of the components of the system of internal control, including the required evaluations thereof and the effect of any identified deficiencies, to the auditor’s identification and assessment of the risks of material misstatement at the financial statement level.

*Stand-Back and Paragraph 18 of AU-C section 330*

In considering the risk identification and assessment process, the ASB has also proposed a new “stand-back” requirement (paragraph 36), which is intended to drive an evaluation of the completeness of the identification of significant classes of transactions, account balances, and disclosures by the auditor. In turn, this helps drive the completeness of the identification of the risks of material misstatement (refer to the section on Identifying and Assessing the Risks of Material Misstatement above for further explanation of the process that the auditor may follow to determine the significant classes of transactions, account balances and disclosures).

The stand-back is intended to focus on material classes of transactions, account balances, or disclosures that have not been determined to be significant (that is, the auditor has not identified any risks of material misstatement that are reasonably possible and therefore has not identified any relevant assertions).

Paragraph 18 of extant AU-C section 330 is also targeted at “material” classes of transactions, account balances, and disclosures, and requires substantive procedures with respect to relevant assertions for all such classes of transactions, account balances, and disclosures. In developing the scope of work for the project to revise AU-C section, paragraph 18 of AU-C section 330 was included because of inconsistent interpretations in practice about how the requirement should be applied. The ASB agreed to further consider the interaction of paragraph 18 of AU-C section 330 with the revisions proposed to extant AU-C section 315, including whether this paragraph is still needed.

The ASB decided to retain paragraph 18 of AU-C section 330. It should be noted that a difference exists between paragraph 18 of ISA 330 and paragraph 18 of extant AU-C section 330 because at the time AU-C section 315 was originally developed, the ASB decided to align paragraph 18 of the original standard with the PCAOB, thus creating a difference between paragraph 18 of ISA 330 and paragraph 18 of extant AU-C section 330. In deliberating the development of the proposed SAS, the ASB agreed that paragraph 18 of AU-C section 330 should be amended to require the auditor to design and perform substantive procedures for all relevant assertions related to each *significant* (instead of material) class of transactions, account balance, and disclosure. The intent of this conforming amendment is to more fully align the wording of paragraph 18 of AU-C section 330 with the wording in PCAOB standard AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*. This change is reflected in appendix G to 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?

## V. *Audit Documentation*

Paragraph 38 of the proposed SAS includes the key matters that, in applying the requirements of the proposed SAS and the related application material, should be included in the audit documentation. This requirement includes the rationale for the significant judgments made in identifying and assessing the risks of material misstatement.

### **Request for Comment**

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

## **Guide for Respondents**

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view, as well.

Written comments on this exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after September \_\_, 2020, for one year. Responses should be sent to Sherry Hazel at [Sherry.Hazel@aicpa-cima.com](mailto:Sherry.Hazel@aicpa-cima.com) and received no later than November \_\_, 2020.

## **Comment Period**

The comment period for this exposure draft ends on November \_\_, 2020.

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(2020–2021)**

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**PROPOSED STATEMENT ON AUDITING STANDARDS**  
*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

**TABLE OF CONTENTS**

|  | Paragraph |
|--|-----------|
| <b>Introduction</b>  |           |
| Scope of This Proposed SAS .....   | 1         |
| Key Concepts This Proposed SAS.....  | 2–8       |
| Scalability .....  | 9         |
| Effective Date .....   | 10        |
| <b>Objective</b> .....   | 11        |
| <b>Definitions</b> .....   | 12        |
| <b>Requirements</b>  |           |
| Risk Assessment Procedures and Related Activities .....  | 13–18     |
| Understanding the Entity and Its Environment, and the Applicable Financial Reporting Framework .....   | 19–20     |
| Understanding the Components of the Entity’s System of Internal Control .....  | 21–27     |
| Identifying and Assessing the Risks of Material Misstatement.....  | 28–34     |
| Evaluating the Audit Evidence Obtained from the Risk Assessment Procedures .....   | 35        |
| Classes of Transactions, Account Balances and Disclosures that Are Not Significant, but Which Are Material.....  | 36        |
| Revision of Risk Assessment.....   | 37        |
| Audit Documentation.....   | 38        |
| <b>Definitions</b> .....   | A1–A14    |
| <b>Application Material</b>  |           |
| Risk Assessment Procedures and Related Activities .....  | A15–A52   |
| Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework and the Entity’s System of Internal Control ..... | A53–A204  |
| Identifying and Assessing the Risks of Material Misstatement.....  | A205–A252 |
| Evaluating the Audit Evidence Obtained from the Risk Assessment Procedures .....   | A253–A255 |
| Classes of Transactions, Account Balances and Disclosures that Are Not Significant, but Which Are Material.....  | A256–A258 |
| Revision of Risk Assessment.....   | A259–A264 |

|  |             |
|--|-------------|
| <b>Appendix A — Considerations for Understanding the Entity and its Business Model.....</b>    | <b>A265</b> |
| <b>Appendix B — Understanding Inherent Risk Factors .....</b>                                  | <b>A266</b> |
| <b>Appendix C — Understanding the Entity’s System of Internal Control.....</b>                 | <b>A267</b> |
| <b>Appendix D — Considerations for Understanding an Entity’s Internal Audit Function .....</b> | <b>A268</b> |
| <b>Appendix E — Considerations for Understanding Information Technology (IT).....</b>          | <b>A269</b> |
| <b>Appendix F — Considerations for Understanding General IT Controls .....</b>                 | <b>A270</b> |
| <b>Appendix G — Considerations Regarding the Use of External Information Sources .....</b>     | <b>A271</b> |

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