



November 25, 2020

Auditing Standards Board  
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To whom it may concern:

On behalf of the National State Auditors Association, we appreciate the opportunity to respond to the AICPA's proposed Statement on Auditing Standards entitled *Understanding the Entity and its Environment and Assessing the Risk of Material Misstatement*.

Our responses to the specific questions posed in the exposure draft follow:

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 believe the requirements and application material of the proposed SAS are capable of being applied to the audits of entities with a wide range of sizes, complexities, and circumstances. Examples included in the narrative provide useful suggestions on how to scale procedures for smaller entities.

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?*

We believe the requirements relating to the auditor's understanding of each component of the entity's system of internal control have been appropriately enhanced and clarified. Furthermore, the proposed SAS provides additional details to help clarify what auditors should be gaining an understanding of with respect to each component of the entity's system of internal control as well as why the auditors need that understanding, and how that understanding should be used in identifying and assessing the risks of material misstatements.

- 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?*

We believe that the requirements related to the auditor's identification of controls that address the risks of material misstatement have been appropriately enhanced. The information included in the application material provides sufficient guidance to help auditors understand



how to identify controls that address the identified risks of material misstatement in both large and small entities of various complexities.

However, we believe the requirements are overly complex in their presentation. We suggest combining paragraphs 26.b and 26.c to make the requirements and related application material easier to follow. 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.

- 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?*

We believe the terminology and related application material is clear. However, the Board has historically included considerations for governmental entities, and it is important to acknowledge that while governmental entities are subject to the AICPA's generally accepted auditing standards, they may use either the U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government*, also known as the "Green Book," or the internal control framework of COSO. The Green Book is based on, and uses the same five elements as, COSO. Therefore, we believe 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?*

We believe 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 appear 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. In addition, 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 relate to IT applications that are determined to be relevant.

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?*

We support the new concepts and related definitions of significant classes of transactions, account balances, and disclosures, and their relevant assertions in the proposed SAS. We believe that the new definitions will result in a better understanding and a more consistent



application of the requirements contained in the proposed SAS. We also believe that sufficient guidance was included in both the requirements and the application material to allow the auditor to properly apply these new concepts during the risk assessment process.

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

We support the introduction of the spectrum of inherent risk into the proposed SAS. We believe the guidance around inherent risk factors will assist auditors in more effectively assessing risk and alleviates the need for a separate identification and assessment of significant risks, as high levels of inherent risk are indicative of significant risks. We suggest the Board include additional examples of where certain risks might be categorized along the spectrum to help auditors make more consistent inherent risk assessments.

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, we support the separate assessments of inherent and control risk.

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 believe it is clear that if the auditor does not contemplate testing the operating effectiveness of controls, or is not required to test controls, control risk should be assessed at the maximum (i.e., the assessment of the risk of material misstatement is the same as the assessment of inherent risk).

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 the requirement in paragraph 26d (to evaluate design and determine implementation of certain control activities) is clear. We see this as necessary as such evaluation informs the nature, timing, and extent of audit procedures. This would be especially true for journal entries because the manner in which an entity incorporates information from transaction processing into the general ledger, and eventually the financial statements, ordinarily involves the use of journal entries, whether standard or nonstandard, automated or manual.

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, on the determination of significant risks, and it appears appropriate to use the spectrum of inherent risk to assist in the determination of significant risks.

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 believe the proposed changes to paragraph 18 of AU-C 330 are clear and appropriately resolve the confusion with extant language. However, the “stand back” requirement in paragraph 36 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-and-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 agree that the documentation requirements are clear and appropriate. However, for consistency, we suggest that the Board refer to paragraphs 17 and 18 in paragraph 38(a).

In addition to our feedback on the specific questions in the exposure draft, we have two additional comments and some editorial suggestions we believe the Board should consider as it finalizes this document.

- Paragraph A257 – The example provided is confusing; therefore, we suggest that the Board use a more common example of a class of transactions, account balance, or disclosure for which there are no relevant assertions identified. For example, a disclosure element related to the significant accounting policies or a disclosure that disaggregates an account balance may have no identified risks of material misstatement at the relevant assertion level. Without additional context of the circumstances of the example disclosure provided, it seems that a disclosure about executive compensation could be susceptible to material misstatement for certain assertions.
- Paragraph A267 – Appendix D: We suggest revising the first sentence of *Appendix D—Consideration for Understanding an Entity’s Internal Audit Function* as follows to clarify that it is application guidance and other explanatory material (see bold font for suggested additions):



This appendix provides further consideration **the auditor may make** relating to understanding the entity's internal audit function when such a function exists.

- Editorial Comments:

1. Footnote 13 in paragraph A11 refers to paragraph A43a of AU-C section 200. Paragraph A43 of AU-C section 200 relates to control risk and does not have sub-paragraphs.
2. Paragraph A107 – referring to the auditor's understanding of the nature of the components of the entity's system of internal control, the paragraph states "It may also influence the auditor's identification and assessment of the risks of material misstatement in different ways (see paragraph A94)..." Paragraph A94 states, "The auditor's identification of risks of material misstatement at the assertion level and assessment of inherent risk may also be influenced by audit evidence obtained by the auditor in performing other risk assessment procedures, further audit procedures, or in fulfilling other requirements in GAAS (see paragraph A105)." Paragraph A105 states, "Appendix E provides further guidance on understanding the entity's use of IT in the components of the system of internal control."

The connections between these paragraphs that call for these references is not clear.

3. Paragraph A140 contains a circular reference (i.e., it refers to paragraph 140).
4. The last sentence of paragraph A245, "Determining risks for which substantive procedures alone do not provide sufficient appropriate evidence." does not appear to be a complete thought.
5. On pdf page 139 of the ED, in paragraph A43, consider deleting the s from the word "accounts" in the sentence that begins with "For example" since the word "balances" is being added.
6. On pdf page 141 of the ED, should the first complete sentence on that page refer to paragraph A71 instead of paragraph A66? It appears paragraph A71 defines the characteristics of a less complex entity to which that sentence refers. If so, we would also recommend excluding the word "smaller" from paragraph A71 to be consistent with paragraph A70.

We appreciate the opportunity to respond to such an important document. Should you have any questions or need additional information regarding our response, please contact Sherri Rowland of NSAA at (859) 276-1147 or me at (225) 339-3800.

Sincerely,

Daryl Purpera  
President, NSAA