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November 25, 2020

Auditing Standards Board  
American Institute of Certified Public Accountants  
1345 Avenue of the Americas, 27<sup>th</sup> floor  
New York, NY 10019

Via Email to [CommentLetters@aicpa-cima.com](mailto:CommentLetters@aicpa-cima.com)

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

Dear Board members and staff:

Grant Thornton LLP appreciates the opportunity to comment on Proposed Statement on Auditing Standards (SAS), *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (proposed SAS). We support the Board's project to enhance the auditing standards related to the auditor's risk assessment to promote greater audit quality. We found the definitional changes and the introduction of the spectrum of inherent risk to be helpful. However, we believe that the level of prescription of the requirements could reduce the overall scalability of the proposed standard.

We are concerned that adopting the standard, as proposed, could exacerbate the execution challenges that currently exist in practice. For example, a current challenge relates to auditors not obtaining a sufficient understanding of internal control to inform risk assessments. The proposed standard contains extensive requirements related to understanding the entity's system of internal control in an attempt to clarify what, exactly, the auditor should do. However, we do not believe the proposed standard is clear enough to enable the auditor to comprehend how that understanding impacts the auditor's response to identified risks of material misstatement. This could create a situation where obtaining the understanding will be cursory at best because there ultimately is no impact on the auditor's response to identified risks of material misstatement at the assertion level. On the other hand, we believe there are good reasons why the auditor should understand the system of internal control and IT environment. This understanding should inform the judgments about the nature,

timing, and extent of the response to the risks of material misstatement. Expanding the requirements and related work effort in this area, while appearing to provide no clear connection to the auditor's response, will not likely yield enhanced audit quality.

We are also concerned that the proposed standard could create operational challenges, particularly for auditors in the United States that also follow the standards of the PCAOB. We provide examples of these potential challenges below.

We also believe the volume of application guidance makes the proposed standard difficult to navigate. While we support the Board's efforts to harmonize its standards with International Standards on Auditing (ISAs), this should not be a rote exercise of wholly accepting the ISAs with minimal changes and without due consideration of the U.S. jurisdiction and the AICPA standard-setting structure. We feel strongly that the audit and accounting guides here in the U.S. can be better leveraged to make the proposed standard more understandable without creating significant divergence from the ISAs.

We respectfully submit our responses to the requests for comment listed in the proposed SAS, along with additional observations, for the Board's consideration.

### **Responses to requests for comment**

#### **Question 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 found certain clarifications and definitional changes helpful, and those changes could be beneficial to enhancing audit quality. Nevertheless, we found the proposed standard overwhelming, which can inhibit understandability. There are 263 paragraphs of application guidance and six appendices to this standard. Over 40 paragraphs and an appendix relate to one requirement – understanding the entity and its environment. We noted that 107 paragraphs plus three appendices relate to understanding internal controls (also refer to our response to Question 7 below). The remaining requirements have 112 paragraphs of application guidance and two additional appendices altogether. It is our view that the proposed standard reads more as an audit methodology, and the level of detail and prescription could lead to further confusion and inconsistencies in practice.

We believe there is a significant opportunity to better streamline the proposed standard and make it more manageable by moving the appendices and a lot of the application guidance into the risk assessment guide. The guide is a more appropriate location for a lot of this guidance, including the appendices and would provide better context to the proposed content than if it were retained in the standard. We do not view this approach as a divergence from the ISAs because the auditor is required to consider the U.S. audit guides in planning and performing the audit, and audit guides are not provided or utilized under the ISAs.

#### **Question 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 support the Board’s direction in enhancing and clarifying the requirements related to the auditor’s understanding of the components of the entity’s system of internal control. We believe the clear segregation of those components assists with the auditor’s obtaining the understanding of the entity’s system of internal control. However, we have concerns that the required procedures do not sufficiently assist the auditor with grasping how this understanding impacts the auditor’s risk assessment or related responses.

Specifically, we believe the notion of the “evaluation” of the appropriateness of each component, as required by paragraphs 21b, 22b, 24c, and 25c is unclear, particularly in relation to paragraph 27. We ask the Board to add application guidance that clearly indicates that the evaluation required for each component takes into consideration control deficiencies that may be identified by the auditor. That is, identified control deficiencies inform the evaluation as opposed to the evaluation informing the identification of control deficiencies. The latter could imply an evaluation of design or implementation, which we do not believe is the Board’s intent.

In addition, we found the last sentence of proposed paragraph A203 to be problematic. As drafted, it implies that the auditor is required to identify control deficiencies, which is inconsistent with existing requirements where the auditor determines whether control deficiencies have been identified. In order to make this proposed paragraph more consistent with existing standards, we recommend that it reads as follows, “Such determination may be an indicator that a control deficiency exists.”

- 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 agree with the Board’s direction relative to enhancing and clarifying the requirements related to the identification of controls that address the risks of material misstatement. However, we believe these requirements could be enhanced. Refer to our response in Question 8 below for further detail and our recommendations to clarify the requirements.

- 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?**

Yes, we believe the terminology in paragraphs 21 through 27 and related application guidance is reasonable and capable of being consistently applied in the context of the 2013 COSO framework. We also believe it is sufficiently framework neutral to be reasonably applied in audits where an alternative framework is used

**Question 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 direction the Board is taking in elevating the auditor's understanding of the IT environment, and we agree that it is necessary to obtain such an understanding. However, we are concerned that the prescription of these requirements reduces their scalability. We are also concerned that the structure of the requirements could create operational challenges for auditors without further application guidance. Specifically, we are concerned that the structure of the requirements implies separate documentation of general IT controls within each component. In practical application, audit firms generally do not document their understanding of general IT controls separately within each component. Instead, auditors obtain the understanding of IT overall, and it is usually documented as such. We recommend the Board add application guidance about how auditors may consider and document general IT controls in aggregate, and not necessarily discretely within each component, in order to mitigate any potential inappropriate inferences auditors may make based on the structure of the requirements.

In addition, we disagree with the application guidance provided in A251. That paragraph states the following.

When the auditor plans to test the operating effectiveness of an automated control, the auditor may also plan to test the operating effectiveness of the relevant general IT controls that support the continued functioning of that automated control to address the risks arising from the use of IT...

This proposed guidance suggests that it could be appropriate in some circumstances not to test general IT controls and may be read as being contradictory to proposed paragraph A35 of AU-C section 330. We believe that if an auditor plans to test the operating effectiveness of an automated control, relevant general IT controls would need to be tested as well. We ask the Board to reconsider this application guidance as we believe it could lead auditors down a path of inadequately supported conclusions related to the operating effectiveness of automated controls.

**Question 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. We believe the guidance could be enhanced by clarifying that the approach to identifying and assessing the risks of material misstatement begins at the financial statement level with the auditor's overall understanding of the entity and its environment and works down to the significant classes of transactions, account balances and disclosures and their relevant assertions. We refer the Board to the "top-down approach" set forth in the requirements of AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, which is also consistent with the PCAOB's risk assessment standards. This approach will focus attention on the significant classes of transactions, account balances and disclosures and the assertions that present a reasonable possibility of material misstatement. As such, it is possible that not every account in the trial balance will be subject to audit procedures. Without this clarification, we are concerned that auditors may feel compelled to identify everything that is simply above the determined materiality amount as a significant class of transactions, account balance, or disclosure (see our response to Question 10 for more information).

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

We support the concept of a spectrum of inherent risk. We believe the profession could benefit from examples illustrating what the spectrum of inherent risk may comprise in the updated risk assessment audit guide. In many circumstances, audit firms have adopted a spectrum approach in their methodologies today. Therefore, we would expect that audit firms' current practice would satisfy the new requirements, and that the introduction of the spectrum of risk would not necessarily significantly change practice for such auditors.

**Question 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 requirement to perform separate assessments of inherent and control risk at the assertion level. However, we have concerns about when control risk is required to be assessed at maximum; refer to our response to Question 7 below.

**Question 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?**

As noted in our response to Question 6 above, we are concerned that the requirements, as drafted, are overly limiting because they do not allow for situations where the entity has controls in place that are effectively designed and implemented (that is, reliance on design). We believe that effective design and implementation could be an input or consideration in designing the appropriate response to risks of material misstatement. Control risk is an entity risk that exists independently of the audit. Operationally, control risk can be assessed by determining control reliance.

Audit procedures to evaluate design, determine implementation, and determine operating effectiveness support the control risk (or control reliance) assessment. Audit sampling theory, including the audit risk model, also supports this approach.

The second bullet in A107 indicates that the auditor's understanding of the entity's information system and communication and control activities is more likely to affect the identification and assessment of risks of material misstatement at the assertion level. However, the two examples provided in the application guidance (paragraphs A202 and A252) are based on the notion that controls are not appropriately designed and implemented. Specifically, the first example in paragraph A252 reads as follows.

The auditor's understanding of internal control may indicate that controls are not designed or implemented appropriately, or the entity's control environment does not support the effective operation of controls. In this case, there is no point in testing controls; ***the further audit procedures will consist solely of substantive procedures*** (emphasis added).

In this case, the auditor that determines controls are effectively designed and implemented, absent testing the controls (which may not be done for a variety of reasons), will also be required to design further audit procedures that will consist solely of substantive procedures. We believe there should be a difference between an audit response where design and implementation are effective and where design and implementation are not effective. This differentiation would more clearly align with how the auditor's understanding affects the identification and assessment of risks of material misstatement, as well as the related responses.

Therefore, the profession could benefit significantly from clarification of how the auditor's understanding of controls impacts the auditor's response to risks of material misstatement and the design of audit procedures that address those risks, as a control risk assessment of "maximum" is clearly evident only when applying audit sampling.

**Question 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)?**

As proposed, the requirement related to understanding the journal entries process is handled more broadly under the Information and Communication component. It is unclear to what extent an auditor would need to understand journal entries at the assertion level. As structured in a sub-bullet to paragraph 26a, the journal entries requirement implies that an auditor may need to "go deeper" on controls over journal entries. Because the notion is broader than the other sub-bullets to paragraph 26a, we recommend making the controls over journal entries its own separate bullet under paragraph 26 and clarifying the associated application guidance. Paragraph 26d would then require revision to incorporate the new, separate bullet on controls over journal entries.

**Question 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?**

While we appreciate the Board's views regarding convergence with the international standard, we are concerned about the potential inconsistencies the new definition of "significant risk" could create in the US jurisdiction when compared to the definition used by the PCAOB. We believe such inconsistency could create operational challenges for firms whose methodologies contemplate both AICPA and PCAOB standards. We do not believe the Board intends for auditors to identify significant risks differently under US GAAS than under PCAOB standards. Therefore, our concerns would be alleviated by adding application guidance that bridges the notion of "special audit consideration" used in the PCAOB's definition of significant risk to the proposed definition in the ED.

**Question 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 generally agree with including a stand-back requirement in the proposed SAS. However, we are concerned that auditors might infer that the notion of "materiality" as used in paragraph 36 indicates that any general ledger balances that are quantitatively material should be subjected to audit procedures. We do not believe this is the Board's intention. Materiality is a determination made at the level of financial statement line items, not at the level of general ledger accounts. Not every general ledger account that is simply above the determined materiality amount needs to be considered significant. This ambiguity could have negative unintended consequences, particularly in group audit situations. Therefore, we recommend adding application guidance that (1) further clarifies the notion of materiality at the financial statement level and (2) includes a consideration of the size and composition of the class of transaction, account balance, or disclosure, which is a concept that currently exists in paragraph A50 of AU-C section 940.

We further agree with the conforming amendment proposed to paragraph 18 of AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. We believe these proposed revisions would promote greater consistency with the standards of the PCAOB and audit quality, while not diverging from the ISAs.

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

We believe the proposed requirement related to audit documentation is clear and appropriate.

**Additional observations**

We identified the following additional observations related to the proposed SAS.

- We are concerned that paragraph 15b is limited only to other engagements performed by the engagement partner. We believe information from other sources

would also include, when applicable, other services provided to the entity by the engagement partner's firm.

- Paragraph 18 could be clearer if the requirement indicates that it applies to engagement team members that are not key engagement team members (that is, other engagement team members). Otherwise, by splitting the requirement into two paragraphs, in comparison to the extant requirement, it suggests a one-way communication from the engagement partner to key engagement team members that were not involved in the discussion in paragraph 17.
- We question why paragraph A52 is limited to governmental entities. There are other types of entities in the U.S. that may be subject to additional audit or other compliance requirements as part of the financial statement audit. We believe this guidance could be applied more broadly to those entities as well.

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We would be pleased to discuss our comments with you. If you have any questions, please contact Bert Fox, National Managing Partner of Professional Standards, at (312) 602-9080 or [Bert.Fox@us.gt.com](mailto:Bert.Fox@us.gt.com).

Sincerely,

/s/ Grant Thornton LLP