



ILLINOIS CPA SOCIETY

December 4, 2020

AICPA Auditing Standards Board
CommentLetters@aicpa-cima.com

RE: Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement

Dear Committee Members:

The Illinois CPA Society (ICPAS) is a statewide membership organization, with over 23,000 professionals dedicated to enhancing the value of the CPA profession. Founded in 1903, ICPAS is one of the largest state CPA societies in the United States. ICPAS represents Illinois CPAs in public accounting and consulting, corporate accounting and finance, not-for-profit, government and education organizations as well as affiliate member groups for students, educators, international professionals, and related non-CPA finance professionals.

The ICPAS Audit and Assurance Services Committee (the “Committee” or “we”) is pleased to comment on the proposed Statement on Auditing Standards: *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The organizational and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These comments and recommendations represent the position of the Committee rather than any individual members of the Committee, the organizations with which such members are associated, or the ICPAS Board.

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?

The Committee applauds the continued efforts to ensure that new standards are properly scalable. The Committee appreciates the numerous examples provided that give auditors latitude in applying the standards for entities of different size and complexity, however, as described below, we believe the Board could go even further in addressing difficulties encountered by small and mid-sized audit firms.

Our experience is that many of the current risk assessment compliance issues are arising within small to mid-sized firms that do not have the same resources as larger firms. We believe the ASB would see fewer compliance issues if it provided more guidance to these firms in areas such as assessing inherent risk, linking risk of material misstatement to audit procedures and designing walk-through procedures for the significant controls identified by the auditor.

As discussed further below, we believe the revised definitions and concepts proposed in the standard may have the effect of making the risk assessment process more difficult for firms without significant resources to develop internal practice aids.

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?



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The Committee believes that the requirements related to the auditor’s understanding of the control environment, risk assessment process, monitoring, and information systems and communications are appropriately enhanced and clarified and are clear with respect to why the understandings are obtained and how they inform the risk identification and assessment process. The application and other explanatory material and Appendix C are quite impactful in that regard.

With respect to the requirements surrounding control activities, the Committee does believe the overall explanation of the component and its relationship to risk assessment is clear, but has some questions with its application and some suggested enhancements as outlined below and also in the Committee’s response to Question 8 below.

For control activities, the Committee seeks clarification on the interaction between Paragraph 26.a.iv, Paragraph 13 and some of the application material. Specifically, Paragraph 26.a.iv and its connection to Paragraph 13 appears to indicate that all risks of material misstatement identified require an evaluation of control activities, which is in line with what the Committee believes to be existing guidance/practice and that also aligns with A143 in the proposed SAS. However, the application and other explanatory material at A181 provides examples and instances that the auditor may consider in applying Paragraph 26.a.iv. While we appreciate the additional application material, at A181, the Committee is not certain that it clearly articulates, when read in connection with Paragraph 26 and 13, that only certain control activities require design and implementation evaluation when assessing risk.

A few additional observations related to the proposed standard and the application and other explanatory material related to the system of internal control are as follows:

- **Paragraph 22 on risk assessment discusses obtaining an understanding of the entity’s process for assessing the significance of the identified risks, including the likelihood of their occurrence (22.a.ii). Considering that Paragraph 23 directly refers to RMMs, and the definition of an RMM includes both likelihood and magnitude, we encourage the ASB to consider including “magnitude” as well in Paragraph 22.a.ii.**
- **Paragraph 24 on monitoring includes discussion as to who may be involved (e.g., an internal audit function) and the sources of information used, but it does not discuss what the Committee believes to be relevant considerations such as the independence and objectivity of the party performing the monitoring (e.g., the self-monitoring threat), the completeness of the monitoring (in relation to the entity’s risk assessment) and the timeliness of monitoring activities. The Committee feels all the aforementioned are relevant in assessing the system of internal control and RMMs and including as part of Paragraph 24 would enhance the guidance in the proposed standard.**
- **The Committee noted that certain areas of the proposed SAS and its application and other explanatory material do not clearly state that inquiry alone is not sufficient for risk assessment. We feel that adding such explicit guidance to Paragraph 14 and its application material (A23-25) and A101 would help avoid any risk of misapplication by auditors.**

- 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?**

The Committee feels that the requirement to identify controls and examples of such control activities is enhanced in the proposed standard, but as noted in the responses to Questions 2a and



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8, does have some concern with respect to the clarity of the requirements and its application by the auditor.

The Committee does feel that the proposed standard and its application and other explanatory material are clear with respect to considerations for obtaining an understanding of a system of internal controls for smaller and less complex entities, with sufficient examples provided to the auditor regarding scalability and how common characteristics of less complex entities may impact risk assessment.

The Committee did identify a few enhancements, however, with respect to scalability considerations:

- **Paragraph A112 discusses in the second bullet point that independence of those charged with governance may be deemed “not relevant” in certain situations such as when the role of governance is undertaken by an owner-manager. While the Committee agrees that independence is not an issue and thus “not relevant”, there may be risks associated with the involvement of owner-managers, and the Committee feels like using the phrase “not relevant” may have an unintended consequence of having auditors feel governance structure is not applicable to its risk assessment at all. The Committee, therefore, recommends an expansion of the discussion, such as the following, to ensure that auditors still consider it in risk assessment: “If the role of governance is undertaken directly by the owner-manager, the auditor may determine that the independence of those charged with governance is not relevant. However, auditors should still consider the impact of this organizational structure on the risks of material misstatement including any potential risks of management bias or management override.”**
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 - **Paragraph A159 refers to “larger, more complex” entities. The Committee noted throughout the Explanatory Memorandum and other sections of the proposed standard that size is not necessarily correlated with complexity and suggests that the ASB remove the size reference in the application and other explanatory material to align better with the rest of the standard.**
- 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?**

The Committee feels that the reference to the COSO framework and the terminology used in Paragraphs 21-27 and related application and other explanatory material is clear and capable of consistent interpretation.

3. **Are the enhanced requirements and application material related to the auditor’s understanding of the IT environment, the identification of the risks arising from the entity’s use of IT, and the identification of general IT controls clear to support the auditor’s consideration of the effects of the entity’s use of IT on the identification and assessment of the risks of material misstatement?**

Yes, Appendix E & F add an extensive amount of guidance for the auditor on how to evaluate and document the IT environment and risks associated with Information Technology.



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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?

The Committee believes that auditors may have difficulty applying these revised definitions in the manner the definitions are presented. Auditors will typically first decide whether a class of transactions, account balance or disclosure is “significant” and then perform the necessary analysis to determine which audit assertions apply to that item. If “significant” is defined as one “for which there is one or more relevant assertions,” the implication is that the auditor must first determine which assertions apply to all transaction classes, balances and disclosures and then determine “relevance,” which would appear to greatly increase the level of analysis required.

Our concern is that practitioners may perceive that the proposed definitions only serve to make an already complex process more complex instead of clarifying and simplifying the risk assessment process, which we understood to be one of the goals of this standard.

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

The introduction of a spectrum of inherent risk is, in theory, an interesting concept. It can be frustrating when most audit practice aids and methodologies force auditors 2 or 3 options (for example, high, moderate, or low) when assessing risks. Such assessments of risk impact the extent of audit procedures and sample sizes.

However, the Committee is concerned that the concept may have impacts that may be adverse in practice and to practitioners. We believe that there should be equality of outcomes with audits among auditors. That is, two independent auditors should come to the same or similar conclusions regarding inherent risk and, in most cases, perform the same or similar procedures to address those risks. Introducing the spectrum of inherent risk could introduce complexities that could lead to different outcomes in procedures that auditors would perform and potential unreliability in the quality of audits across the industry.

For example, sampling techniques are currently heavily reliant on the assessments of risk. With disparate methods of assessing inherent risks across the industry, sample sizes and testing procedures could be significantly different.

Additionally, we would appreciate if the Board addressed the specifics of scalability of this concept, as it may introduce unnecessary documentation requirements for auditors when auditing less complex businesses.

The introduction of spectrum may be best utilized in areas a spectrum would make the assessment more effective. The spectrum of inherent risk would appear to be most effective for large or highly complex entities, as these entities tend to have a greater number of significant classes of transactions, account balances and disclosures, where the greater precision afforded by the spectrum concept may produce more meaningful assessments of risk.



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

The Committee believes that if separate assessments of inherent and control risk are required, more guidance should be provided to the auditor in determining the risk of material misstatement from a combination of inherent and control risk. Many auditors, particularly when auditing less complex entities, choose not to test controls, so inherent risk ends up being the primary determinant of overall risk of material misstatement. We believe the separate assessments may result in risk assessment errors and unnecessary complexity in the process, particularly for smaller entities.

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?

Overall, the Committee believes that the proposed standard is clear with respect to the need to assess control risk. However, the Committee does have a suggestion regarding the explanatory and other application guidance on how to assess control risk in situations where the auditor does not plan to test the operating effectiveness of controls. Currently, Paragraph 34 and the Explanatory Memorandum states 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 (that is, the assessment of the risk of material misstatement is the same as the assessment of inherent risk)”. The Committee has a concern that the parenthetical statement could be misconstrued and result in an auditor erroneously assessing control risk at the same level as its assessment of inherent risk - versus meaning that control risk is automatically set at 100%. The Committee suggests that the parenthetical statement be removed to avoid confusion or, in lieu of that, add explanatory and other application material showing a mathematical application such as the following is suggested:

- **Risk of material misstatement = inherent risk x control risk**
- **Example with not testing operating effectiveness of internal controls**
 - **75% (RMM) = 75% (inherent risk) x 100% (control risk)**
- **Example with testing operating effectiveness of internal controls**
 - **37.5% (RMM) = 75% (inherent risk) x 50% (control 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)?

The Committee feels that the clarity on the requirements in Paragraph 26d of the proposed SAS are clear for the need to evaluate the design and implementation of certain control activities, with the exception of Paragraph 26.a.iv. Please refer to our response at Question 2 above for questions related to Paragraph 26.a.iv, Paragraph 13 and the related application guidance and explanatory material.

Additionally, the Committee noted that, related to design and implementation, the application guidance in A197 refers to walkthroughs including a re-performance of controls and that walkthroughs may be used in evaluating design and implementation. This appears to be contradictory to Paragraph A196 that states that, for design and implementation evaluations, re-performance is not an option. Paragraph A61 of AU-C 940 is also clear that re-performance is not an option for evaluating design and implementation, so the Committee suggests that management revise A197 to be in line with A196 of the proposed standard and A61 of AU-C 940.



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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?

The Committee agrees with the Board's revised definition. Significant risks should not be determined based on an auditor's response, but the underlying nature of the risk.

See question 5 above for discussion of spectrum of inherent risk discussion. The Committee's opinion is that introducing additional assessments of risks (assessment of magnitude and likelihood of occurrence) by incorporating spectrums of inherent risk unnecessarily complicate the process of identifying 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?

The Committee agrees with the Board's stand-back requirement. Such a requirement allows the auditor to identify risks and formulate responses to risks that may have been overlooked in the initial assessment of risks.

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

Paragraphs 38 and A259-263 have expanded additional guidance to assist the auditor in preparing appropriate documentation based on the risks identified and the complexity of the entity. Paragraph A263, in particular, describes examples in which an auditor of a less-complex entity may be able to combine risk assessment documentation with the auditor's existing documentation of overall strategy. We believe additional examples of this sort will greatly aid auditors at small and mid-sized firms who may not have the same resources as the larger firms, as discussed in question 1.

The Committee appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Genevra D. Knight, CPA
Chair, Audit and Assurance Services Committee

Michael Ploskonka, CPA
Vice Chair, Audit and Assurance Services Committee



APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE ORGANIZATION AND OPERATING PROCEDURES 2020 – 2021

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education and public practice. These members have Committee service ranging from newly appointed to almost 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

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