



441 G St. N.W.
Washington, DC 20548

November 25, 2020

American Institute of Certified Public Accountants
220 Leigh Farm Road
Durham, North Carolina 27707-8110

GAO’s Response to the AICPA’s Exposure Draft, *Proposed Statement on Auditing Standards – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, August 2020

This letter provides GAO’s response to the American Institute of Certified Public Accountants’ (AICPA) Auditing Standards Board’s (ASB) exposure draft, *Proposed Statement on Auditing Standards – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. GAO provides standards for performing high-quality audits of government organizations, programs, activities, and functions and of government assistance received by contractors, nonprofit organizations, and other nongovernment organizations with competence, integrity, objectivity, and independence.¹ These standards, often referred to as generally accepted government auditing standards (GAGAS), are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. For financial audits, GAGAS incorporates by reference the AICPA’s Statements on Auditing Standards (SAS).

The ASB seeks to 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) with the requirements proposed in the exposure draft.

We support the ASB’s overall strategy to converge its standards with those of the International Auditing and Assurance Standards Board by

- using the corresponding International Standard on Auditing as the base in developing its standards,
- making certain changes to the language to use terms or phrases that are more common in the United States, and
- tailoring examples and guidance to the U.S. environment.

In addition, we support the proposed SAS and include our responses to each question. Overall, it is our view that the ASB could improve the proposed standard’s clarity by making certain changes to the language to augment the auditors’ understanding and ability to comply with the proposed SAS in the U.S. environment. Our responses to the ASB’s questions and our additional comments follow in the enclosure to this letter.

¹GAO, *Government Auditing Standards: 2018 Revision*, [GAO-18-568G](#) (Washington, D.C.: July 2018).

Thank you for the opportunity to comment on these important issues. If you have questions about this letter or would like to discuss any of the matters it addresses, please contact me at (202) 512-3133 or dalkinj@gao.gov.

Sincerely yours,

A handwritten signature in black ink, appearing to read "James R. Dalkin". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

Enclosure

GAO Responses to AICPA's Auditing Standards Board's (ASB) Request for Comments and GAO's Additional Comments

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 agree that the requirements and application material of the proposed Statement on Auditing Standards (SAS) are sufficiently scalable, enabling auditors to apply the proposed SAS to the audits of entities with a wide range of sizes, complexities, and circumstances.

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 that the requirements related to the auditor's understanding of each component of the entity's system of internal control have been enhanced and clarified, and that it is sufficiently clear why the auditor should obtain an understanding of each component of the entity's system of internal control and how this understanding 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?**

We believe that the requirements related to the auditor's identification of controls that address the risks of material misstatement have been enhanced and clarified and that it is sufficiently clear how controls that address the risks of material misstatement are identified.

- 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?**

In our view, the terminology in paragraphs 21 through 27 and related application material of the proposed SAS is clear and capable of being consistently interpreted for audits of entities that use the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) framework. However, for the federal government, the Federal

Managers' Financial Integrity Act requires (1) federal agency executives to periodically review and annually report on an agency's internal control systems and (2) the Comptroller General to prescribe internal control standards.² These standards are in GAO's *Standards for Internal Control in the Federal Government*, commonly referred to as the Green Book.³ The Green Book is also adopted by numerous state, local, quasi-governmental entities, and not-for-profit organizations as a framework for an internal control system. Accordingly, auditors of these entities, who make up a significant amount of the users of the American Institute of Certified Public Accountants' (AICPA) SAS, primarily use the Green Book related to standards for internal control.

Toward that end, we encourage the ASB to continue to reference the Green Book in each SAS that refers to the COSO framework—as this is especially relevant to auditors of governmental entities and certain not-for-profit organizations. For example, AU-C section 940, *An Audit of Internal Control over Financial Reporting That Is Integrated With an Audit of Financial Statements*, states that the Green Book and the COSO framework provide suitable and available criteria against which management may evaluate and report on the effectiveness of the entity's internal control over financial reporting.⁴

We suggest the ASB reference the Green Book in paragraph A6 as follows:

A6. The integrity of information may include the completeness, accuracy, and validity of transactions and other information. Although this proposed SAS does not prescribe the use of a particular internal control framework, the auditor may find the following guidance regarding the concepts encompassed by the term validity, from COSO's 2013 *Internal Control—Integrated Framework* (COSO framework), helpful: “Recorded transactions represent economic events that actually occurred and were executed according to prescribed procedures. Validity is generally achieved through control activities that include the authorization of transactions as specified by an organization’s established policies and procedures (that is, approval by a person having the authority to do so).” The U.S. Government Accountability Office’s *Standards for Internal Control in the Federal Government* (the Green Book) provides similar guidance on validity.⁵

In our review of the COSO framework and Green Book, we noted that both frameworks use the terms internal control and systems of internal control without significant differentiation. As such, we suggest the following changes to paragraph A14.

A14. Internal control frameworks may use different terms that are similar to the concept of system of internal control. For example, the 2013 COSO framework

²Pub. L. No. 97-255, § 2, 96 Stat. 814 (Sept. 8, 1982), *codified* at 31 U.S.C. § 3512(c), (d).

³GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014).

⁴See para. .A16 of AU-C section 940, *An Audit of Internal Control over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, Professional Standards).

⁵See Green Book, para. 11.05, Validity - Recorded transactions represent economic events that actually occurred and were executed according to prescribed procedures. [GAO-14-704G](#)

and the Green Book use the terms internal control and systems of internal control interchangeably.

- 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?**

It is our view that the enhanced requirements and application material related to the auditor's understanding of the information technology (IT) environment, identification of the risks arising from IT, and identification of general IT controls are 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.

- 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 introduction of the new concepts and related definitions of significant classes of transactions, account balances, and disclosures and their relevant assertions. In our view, there is sufficient guidance to explain how they are determined and how they assist the auditor in identifying where risks of material misstatement exist.

The explanation of the risks of material misstatement in paragraph 5 of the proposed SAS states the following:

AU-C section 200 explains that risks of material misstatement are assessed at the assertion level in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. For purposes of generally accepted auditing standards (GAAS), a risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).

We believe that it would enhance the auditor's understanding and ability to consistently apply the proposed standard if the ASB provided guidance on the meaning of "reasonable possibility" in AU-C section 315. While we recognize that the definition of reasonable possibility is provided in other AU-C sections, we believe that providing the definition in AU-C section 315 will assist auditors in correctly and consistently applying the standards.

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

We support the introduction of the phrase spectrum of inherent risk into the proposed SAS.

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 separate assessments of inherent and control risk in relation to all risks of material misstatement at the assertion level.

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 suggest better clarifying the requirement to assess control risk when the auditor does not plan to test the operating effectiveness of controls. In our view, further clarification is needed to assist auditors in correctly and consistently applying this requirement. Paragraph 34 of the proposed SAS states, "If the auditor does not plan to test the operating effectiveness of controls, the auditor's assessment of control risk should be such that the auditor's assessment of the risks of material misstatement is the same as the assessment of inherent risk."

It is our view that this language is unclear. Such language may imply that the auditor is not required to assess control risk when the auditor does not plan to test the operating effectiveness of controls. A requirement that is presumptively mandatory should state what the auditor is to do versus not to do. We suggest the ASB clarify the requirement for how the auditor assesses control risk when the auditor does not plan to test the operating effectiveness of controls. The ASB could consider requiring the auditor to assess control risk equivalent to the auditor's assessment of inherent risk at the assertion level when the auditor does not plan to test the operating effectiveness of controls.

In addition, the application guidance in paragraphs A248 through A252 does not clearly address the requirement for assessing control risk when the auditor does not plan to test the operating effectiveness of controls. Paragraph A252 in the application guidance states the following:

Regardless of whether the auditor plans to test the operating effectiveness of controls for the purpose of assessing control risk, the auditor's understanding of the entity and its environment, the financial reporting framework, and the entity's [system of] internal control informs the auditor's design of further audit procedures.

Examples follow:

- The auditor's understanding of [the entity's system 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 control. In this case, there is no point in testing controls; the further audit procedures will consist solely of substantive procedures.

We suggest the ASB consider adding application guidance that clarifies the auditors' responsibilities for assessing control risk when the auditors do not plan to test the operating effectiveness of controls.⁶

In addition, in our review of paragraph A252, we identified two areas where the term internal control is used inconsistently with the proposed SAS's terms and definitions. The proposed SAS changed "internal control" to "system of internal control" and updated the definition. Paragraph A252 should be revised to include the terms used in the proposal. We suggest that the proposed SAS be reviewed and updated to ensure that the proposed terms are used consistently throughout the standard, including the Application and Other Explanatory Material section.

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)?

It is our view that the requirement in paragraph 26d of the proposed SAS to evaluate design and determine implementation of certain control activities is reasonably clear.

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 determining significant risks. We agree that significant risks could include risks that are potentially low in likelihood but for which the magnitude of misstatement could be very high if they occurred.

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 support 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.

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

We believe that the documentation requirements in paragraph 38 should be enhanced and broadened to fully capture (1) the auditor's understanding and **evaluation** of the entity and its environment and (2) the entity's information system and communication.

⁶Para. 4 of the proposed SAS provides that "risks at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk is described as the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. Control risk is described as the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's system of internal control."

Paragraph 38 states the following:

The auditor should include in the audit documentation (Ref: par. A259–A263)

- a. the discussion among the engagement team and the significant decisions reached
- b. key elements of the auditor's **understanding** in accordance with paragraphs 19, 21, 22, 24, and 26; the sources of information from which the auditor's understanding was obtained; and the risk assessment procedures performed
- c. the **evaluation** of the design of identified controls, and determination whether such controls have been implemented, in accordance with the requirements in **paragraph 26**; and
- d. the identified and assessed risks of material misstatement at the financial statement level and at the assertion level, including significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made.

Paragraph 38b requires the auditor to document the key elements of the auditor's **understanding** in accordance with paragraphs 19, 21, 22, 24, and 26; the sources of information from which the auditor's understanding was obtained; and the risk assessment procedures performed.

Paragraphs 21 (Control Environment), 22 (The Entity's Risk Assessment Process), 24 (The Entity's Process for Monitoring the System of Internal Control), and 26 (Control Activities) contain the requirements for the auditor to **understand and evaluate** the respective component of the entity's system of internal control. The documentation requirements in paragraph 38b require the auditor to document key elements of the auditor's **understanding** rather than the auditor's **understanding and evaluation** of the requirements relating to the components of the entity's system of internal control. While paragraph 38c requires the evaluation of the design of identified controls, and determination whether such controls have been implemented, in accordance with paragraph 26, this paragraph applies to only the entity's control activities.

We also note that paragraph 38b omits paragraph 25 (Information System and Communication) and believe that it should be added to the documentation requirements in paragraph 38b.

Additional Comments

It is our view that the proposed standard can be further clarified by making changes to the title and selected headings to enhance the auditor's understanding and illustrate continuity in terminology and interconnectedness within the standard.

Consistent with the title of International Standard on Auditing 315, *Identifying and Assessing Risks of Material Misstatement*, we suggest that the ASB change the title of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement*, to convey that the primary objective of the standard is to assess the risks of material misstatement of the financial statements.

We also suggest that the ASB consider updating the headings in AU-C section 315 to be consistent and descriptive of the respective content and to enhance the auditors' understanding and ability to apply the standards consistently. We suggest the following as possible considerations for improving clarity and consistency.

Proposed SAS	GAO proposal
Risk Assessment Procedures and Related Activities	<u>Designing and Performing Risk Assessment Procedures and Related Activities</u>
Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control	<u>Understanding the Entity and Its Environment, the Financial Reporting Framework, and the System of Internal Control</u>
Control Environment (para. 21)	<u>The Entity's Control Environment (para. 21)</u>
The Entity's Risk Assessment Process (para. 22)	The Entity's Risk Assessment Process (para. 22) [no change suggested]
The Entity's Process for Monitoring the System of Internal Control (para. 24)	The Entity's Process for Monitoring the System of Internal Control (para. 24) [no change suggested]
The Information System and Communications (para. 25)	The <u>Entity's</u> Information System and Communications (para. 25)
Control Activities (para. 26)	<u>The Entity's</u> Control Activities (para. 26)
Classes of Transactions, Account Balances and Disclosures That Are Not Significant but Are Material (para. 36)	<u>Evaluating</u> Classes of Transactions, Account Balances, and Disclosures Deemed Material But Not Significant (para. 36)
Revisions of Risk Assessment (para. 37)	<u>Reassessing Risks of Material Misstatement (para. 37)</u>