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STATEMENT ON AUDITING STANDARDS 145: WAS STAKEHOLDER FEEDBACK INCORPORATED IN THE FINAL STANDARD?

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ABSTRACT

Understanding the entity's environment and assessing the risk of material misstatement are fundamental components of the audit planning process that have been found deficient by regulators, peer reviews, and research studies. In 2020, the Auditing Standards Board of the American Institute of Certified Public Accountants issued an exposure draft of a Statement on Auditing Standards to clarify and enhance the requirements for auditors to understand an entity's system of internal controls and determine the risk of material misstatement. In addition, the proposal modernized the existing audit requirements regarding information technology use and addressing risks arising from such use. This paper analyzes the comment letters submitted to the Auditing Standards Board to assess the degree of stakeholder agreement with the proposed requirements. Next, the language of the exposure draft is compared to the text of the final standard to determine the degree of standard setters' responsiveness to the feedback they received during the standard-setting process. The analyses suggest general acceptance by respondents, with requests that additional clarifications be provided. The final text of the standard indicates that the standard setters agreed with respondent suggestions. While the final SAS is well received and achieves its aims, further clarification and guidance will be needed for its efficient and effective implementation.

JEL: M42

KEYWORDS: SAS No. 145, AICPA, Entity Environment, Risk Assessment, Material Misstatement, Audit Standards

INTRODUCTION

The auditor's responsibility for gaining an understanding of an entity's business environment (UEE) and assessing the risks of material misstatement (ARMM) forms the foundation of the audit planning process, drives the selection of audit procedures to be performed, and dictates the necessary evidence needed to support the audit opinion (AICPA, 2020). In recent decades, rapid advancements in information technology (IT) have resulted in an increase of the complexity of business environments as IT has become the infrastructure for corporate governance, entity risk management, and legal and regulatory compliance. Underlying the need to understand the IT environment and its risks is the fact that IT has become the primary medium through which audit evidence is gathered during engagements (AICPA, 2020). In addition to the growing complexities of UEE, the role of risk assessment has been highlighted as an area of audit deficiency, especially with regards to understanding and assessing inherent risks of material misstatement (AICPA, 2020). Miller, Cipriano, and Ramsay (2012) noted that there were wide variations between the requirements of the current standards and actual practice when determining inherent risk. They indicated that while standards require inherent risk to be assessed if controls are not present, practicing auditors generally assess inherent risk assuming an underlying baseline bias of expected IT control efficiency.

Authors suggested that such practices undermine audit efficiency and recommended that standards be updated to better emphasize and clarify the separation of inherent risk from control risk in the ARMM.

In an effort to target these perceived deficiencies in auditors' UEE and ARMM resulting from advances in and use of IT, on August 27, 2020, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) announced a proposed standard in a news release on its website, encouraging interested parties to respond to the exposure draft by November 25, 2020, thereby soliciting input from all stakeholders, including public, private, and governmental organizations. The proposed standard aimed to revise the existing standards to clarify and enhance the audit requirements for gaining an understanding of the audit client's system of internal controls and determining the risk of material misstatement. In addition, the proposal included requirements for gaining an understanding of a business entity's use of IT as well as risks associated with the use of IT. Finally, the proposal sought to align the requirements for understanding internal controls with the framework developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The exposure draft provided supporting documents and other materials clarifying why an understanding of the entity's control environment was required, the procedures for obtaining an understanding of each component of the internal control framework, and the methods for determining when controls were relevant to the audit. In targeting the deficiencies in risk assessment, the ASB added specific requirements for assessing inherent risk and control risk separately from each other in relation to all risks of material misstatement, with an emphasis on assigning a maximum control risk level when assessing inherent risk of material misstatement. In addition, the ASB introduced requirements for gaining an understanding of additional inherent risks that arise from the auditor's reliance on IT in assessing control risk for controls that utilize automation or other IT applications.

Following the review of the literature, this paper first examines the comment letters submitted in response to the exposure draft issued by the ASB. The ASB posed 11 questions about how individual auditors, auditing firms, financial statement users, and other stakeholders viewed the contents of the proposal. Next, the paper provides insight into the due process of standard setting by analyzing how the comment letters impacted the final standard (AICPA, 2021) as compared to what was originally proposed. While there was general agreement with the proposed requirements, respondents offered several suggestions for further clarifications and enhancements that the ASB took into consideration in issuing the *Statement on Auditing Standards No. 145* (SAS 145, AICPA, 2021). In addition, the paper proposes a path forward, where the need for additional training and education is addressed related to the new requirements involving risks associated with the use of IT by both auditors and auditees and understanding the role IT plays in an entity's control environment. Finally, potential implementation concerns are discussed that result from the extensive amendments made to other sections of generally accepted auditing standards (GAAS), as the new standard becomes effective for audits conducted on or after December 15, 2023.

BACKGROUND & LITERATURE REVIEW

Recent studies indicate that increases in IT investment have a marked effect on generating higher audit risk for external auditors (Han, Rezaee, Xue, & Zhang, 2016) and suggest a heightened need for auditors to develop a deeper understanding of an audit client's use of IT. In particular, auditors must examine the control activities that incorporate IT functions and additional risks that may arise from the use of IT. Finally, auditors must decide how to assess these inherent risks and the efficacy of the controls implemented to mitigate IT risks (Dzuranin & Mălăescu, 2016; Cangemi, 2016; Omoteso, Patel, & Scott, 2010; Schroeder & Singleton, 2010; and Sexton & Rudman, 2019). While auditors must obtain an understanding of the internal controls of an entity to plan appropriately for the audit, they must also document their understanding of internal controls and their assessment of the risks of using IT (Piercey, 2011; Sexton & Rudman, 2019; Weidenmier & Ramamoorti, 2006). Internal controls are designed by the board of directors and members

of management to provide reasonable assurance that financial information is reliable and mitigates the risks of financial misstatement and fraud (Brasel, Hatfield, Nickell, and Parsons, 2019; Carpenter, 2007). Additionally, internal controls provide reasonable assurance regarding the achievement of the objectives set by management, the effectiveness and efficiency of operations, and compliance with all applicable laws and regulations. To understand the client's environment of internal controls, an auditor must: 1) identify the types of possible misstatements; 2) consider the factors that affect the risks of material misstatements; 3) design tests of controls; and 4) design substantive procedures that address identified risks. In addition, the entity must have in place adequate and effective internal controls for business functions such as acquisition, payment cycle, and inventory control systems to reduce workplace fraud (Munoko, Brown-Liburd, and Vasarhelyi, 2020).

Internal Control Framework – Components of a System of Internal Controls

One of the goals of the proposed SAS was to align the requirements of the proposed standard with the COSO Framework (Framework) in guiding how auditors gain an understanding of and assess an entity's internal controls. The Framework describes five components of internal control that management designs and implements to provide reasonable assurance that its control objectives will be met (Janvrin et al., 2012). These components include: 1) control environment; 2) risk assessment; 3) control activities; 4) information and communication; and 5) monitoring. Each component contains many controls, but auditors concentrate on those designed to prevent or detect material misstatements in the financial statements. According to Janvrin et al. (2012), the Framework includes seventeen broad principles that provide more guidance to support each component and apply across all entities and to each internal control objective of reporting, operations, and compliance. All of the seventeen principles must be present and functioning for internal controls to be effective. The control environment serves as the umbrella for the other four components. The other four components are unlikely to result in effective internal control without an effective control environment, regardless of their quality. Thus, the essence of an effectively controlled organization lies in the attitude of its board of directors and senior management. If top management believes that internal control is important, others in the organization will sense this commitment and respond by implementing and properly carrying out the established controls.

The proposed standard (AICPA, 2020) required that auditors consider the following important control subcomponents to understand and assess the control environment: 1) integrity and ethical values of management, policy statements and codes of conduct; 2) board of directors or audit committee participation in the scrutiny of management's conduct and outcomes; 3) organizational structure and implementation of controls; 4) competence and trustworthiness of employees in general, and in particular of those who implement the primary controls; and 5) the accountability of management and the board of directors to stakeholders. In addition, the final standard (AICPA, 2021) requires that auditors identify and analyze risks that may prevent the organization from achieving its objectives, as follows: 1) identify and assess the risks relating to those entity's objectives; 2) determine how the risks should be managed; 3) consider the potential for fraudulent behavior; 4) monitor changes that could impact internal controls; and 5) identify specific risks related to information technology and financial records. Han, Rezaee, Xue, and Zhang (2016) provide examples of a company that frequently sells products below inventory cost because of rapid technology changes. In such a case, the company must incorporate adequate controls to address the risk of overstating inventory. While management assesses risks as a part of designing and operating internal controls to minimize errors and fraud, auditors assess risks to determine the nature, timing, and extent of audit procedures needed to be performed (Curtis, Jenkins, Bedard, & Deis, 2009). If management effectively assesses and responds to threats, the auditor can conduct a less rigorous audit than when management fails to identify or respond to significant risks. If the auditor is assured that controls will help ensure that necessary actions are taken to address risks to achieve the entity's objectives, the extent of substantive audit procedures will be reduced (Morrill, Morrill, & Kopp, 2012). Consequently, an auditor must identify control activities that: 1) mitigate risks to an acceptable level (e.g., adequate separation of duties and proper

authorization of transactions and activities); 2) establish general controls over technology (e.g., design, implementation, and use of IT); and 3) establish appropriate policies, procedures, and expectations (e.g., adequate documents and records). Thus, the auditor must be assured that the accounting system satisfies all transaction-related management assertions identified for each class of transaction (Eaton, Grenier, & Layman, 2019). In the assessment of risks, auditors must first consider inherent risk. This risk reflects the susceptibility of an assertion concerning an item of financial information to a misstatement that could be material before the consideration of any related controls. Importantly, inherent risk is to be assessed *before* consideration of any related internal controls, meaning that the auditor is to assume that no controls exist. A significant risk of material misstatement exists if the inherent risk is assessed at the high end of the spectrum of inherent risk (DiLeo, 2022). The final standard does not define the spectrum of inherent risk which was a great concern to stakeholders.

Overall, the revision of UEE and ARMM standards arose from the AICPA's Enhanced Audit Quality Initiative, which recognized deficiencies in auditor risk assessment with regards to the requirement of obtaining an understanding of the client's internal controls and factors of inherent risk of material misstatement (AICPA, 2020). Both the ASB exposure draft (AICPA, 2020) and the final standard SAS No. 145 (AICPA, 2021) addressed the perceived need to revise the existing standards to clarify and enhance the audit requirements for gaining an understanding of the audit client's system of internal controls and ARMM. In addition, both documents included requirements for gaining an understanding of a business entity's use of IT as well as risks associated with the use of IT. Furthermore, the ASB sought to align the requirements for understanding internal controls with COSO's internal control framework. When it becomes effective, *SAS No. 145: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* will supersede *SAS No. 122: Clarification and Recodification* and become the new section 315 of GAAS (AICPA, 2021).

DATA AND METHODOLOGY

The ASB requested standard user feedback by posing 11 questions within the exposure draft, with question 2 being divided into three sub-questions. These questions (presented verbatim in Table 1) focus on stakeholder perception of the clarity of requirements within the proposed standard and whether the updated definitions and application materials enhance the auditor's ability to assess an entity's control environment and inherent risk of material misstatement. The ASB requested that stakeholders submit their comments and feedback on the exposure draft by November 25, 2020. The ASB received a total of 33 comment letters in response to the exposure draft. Of the 33 comment letters submitted, 29 were useable for this study. The remaining four comment letters were excluded from our sample, as they did not follow the format requested by the ASB and therefore could not be accurately categorized. Respondents within the sample included 10 professional organizations, 11 accounting firms (including all Big 4 firms), 6 governmental organizations/state auditors, and 2 academics/other.

In quantifying stakeholder responses, answers to the questions in Table 1 for each respondent were categorized by level of agreement. For questions one through six, and nine through eleven, these categories included: 1) those agreeing with the question (*Agree*); 2) those partially or conditionally agreeing with the question given certain revisions be made prior to the final standard being issued (*Partially Agree*); and 3) those disagreeing with the changes to requirements or application material described in the question (*Disagree*). For questions seven and eight, which specifically focus on stakeholder views regarding the clarity of specific proposed requirements, levels of agreement were classified as: 1) those who viewed the requirements as sufficiently clear (*Sufficiently Clear*); 2) those who viewed the requirements as understandable but in need of some improvement or additional guidance to be sufficiently clear (*Needs Improvement*); and 3) those who viewed the language of the proposed SAS requirements and supporting material as being unclear and needing extensive revisions to language and supporting materials (*Unclear*). In cases where a stakeholder skipped or elected to refrain from answering a particular question, a category

of N/A was used. Stakeholder responses to the AICPA's exposure draft requests for comment are described and summarized by question in the next section.

Table 1: ASB Request for Comment Questions

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?
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 risk 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?
b	Have the requirements related to the auditor's identification of controls that address the risk of material misstatement been appropriately enhanced and clarified? Is it clear how the controls that addressed the risks of material misstatement are identified, particularly for audits of smaller and less complex entities?
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 materials of the proposed SAS clear and capable of consistent interpretation for audits of entities that use the COSO framework?
Question 3	Are the enhanced requirements and application materials 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?
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?
Question 5	Do you support the introduction of the spectrum of inherent risk into the proposed SAS?
Question 6	Do you support the separate assessment of inherent and control risk in relation to all risks of material misstatement at the assertion level?
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?
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 control over journal entries)?
Question 9	Do you support the revised definition, and related material, on the determination of significant risk? What are your views on the matters previously presented related to how significant risks are determined based on the spectrum of inherent risk?
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?
Question 11	What are your views with respect to the clarity and appropriateness of the documentation requirements?

Table 1 exhibits a verbatim reproduction of the questions asked to stakeholders for feedback on the AICPA exposure draft 'Proposed Statement on Auditing Standards: Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement' (AICPA, 2020).

Impact of Stakeholder Comments on the Final Standard Issued

The exposure draft (AICPA, 2020) is compared and contrasted to the final standard issued by the AICPA (2021) and the analysis of the extent of stakeholder agreement with the proposed standard is used to determine the responsiveness of the standard-setting process to stakeholder input. The recommendations for revisions made in the comment letters are analyzed to see if the ASB amended the exposure draft to include stakeholder suggestions in the final standard issued. The aim is to understand the efficacy of constituent comments in shaping the standards that govern UEE and ARMM and describe the degree of general acceptance of *SAS 145*. General acceptance leads to high-quality audits which promote efficient financial markets by providing market participants the confidence they need to make informed decisions.

RESULTS

The exposure draft is subdivided into two key parts: 1) obtaining an understanding of the entity's control environment, and 2) identifying and assessing the risk of material misstatement. Questions and stakeholder responses have been sorted into these two categories along with a third category for questions that asked for stakeholder opinion regarding aspects of the entirety of the proposed standard. Each question is discussed below, alongside comparisons between the proposal (AICPA, 2020) and the final standard (AICPA, 2021) that highlight any modifications the ASB made in response to stakeholder comments and recommendations. Tables 2 and 3 present tabulations of stakeholder responses to exposure draft questions by stakeholder entity type (Professional Organization, Accounting Firm, Governmental Auditor, or Academic/Other) and by level of agreement for questions 1 through 6 and 9 through 11 (Agree, Partially Agree, or Disagree) and by perceived clarity for questions 7 and 8 (Sufficiently Clear, Needs Improvement, or Unclear). Questions which respondents did not answer are reflected in the N/A column of the respective tables.

Overall Acceptance of Proposed SAS

Of the 29 comment letters analyzed, only one – a governmental/state auditor – answered favorably (agree or sufficiently clear) to all posed questions. The remaining respondent answers varied across the questions. Tables 2 and 3 indicate that respondents had an overall favorable perception of the proposal, with all questions receiving more than 50% agreement from respondents. Questions 2c and 6 received the most favorable responses, while Questions 2b and 7 received the least favorable responses. This result held true regardless of respondent type. In aggregating respondent answers, the overall perception of clarity and the rate of agreement with all questions was approximately 67%. In discussing the entirety of the proposal, respondents were quick to point out that the length of the exposure draft - 38 requirement paragraphs, 263 application material paragraphs, and 7 appendices – increased the complexity and inhibited understanding. In their attempt to enhance and clarify all aspects of gaining an understanding of an entity's control environment, system of internal controls, and assessing risk of material misstatement arising from inherent risk, significant risks, and risks arising from the use of IT, the ASB drafted a standard that stakeholders viewed as overwhelming, unwieldly, and difficult to navigate. Several respondents expressed concerns that to appropriately apply the proposal would be cost prohibitive and time consuming for smaller firms and for audits of smaller or less complex entities. In looking at the individual parts of the proposed SAS, respondent consensus suggests agreement with adoption of new terms and enhanced definitions. At the same time, respondents gave mixed support when questioned on the clarity in the application materials, specifically with regards to minimum procedures and documentation needed to meet proposed requirements. Stakeholder perceptions of these individual parts are presented in Tables 2 and 3 and are further discussed below.

Obtaining an Understanding of the Entity's Control Environment

The first half of the requirements proposed within the exposure draft focused on enhancing and clarifying the auditor's responsibility to gain an understanding of the audit entity and its system of internal controls. With this goal in mind, question 2 and its subparts focused on asking respondents if the: a) requirements for understanding the components of an entity's system of internal controls had been appropriately enhanced and clarified; b) requirements for identifying controls addressing risk of material misstatement had been appropriately enhanced and clarified; and c) the proposal language is consistent and applicable for audits of entities that use the COSO framework.

Table 2 Stakeholder Response to AICPA Exposure Draft Questions - Level of Agreement

Question	Agree					Partially Agree					Disagree					N/A				
	P	F	G	A	T	P	F	G	A	T	P	F	G	A	T	P	F	G	A	T
	8	5	6	2		1	5	0	0		1	1	0	0		0	0	0	0	
Question 1					21 (72%)					6 (21%)					2 (7%)					0 (0%)
Question 2a	6	7	4	2	19 (66%)	3	3	1	0	7 (24%)	0	1	0	0	1 (3%)	1	0	1	0	2 (7%)
Question 2b	4	5	4	2	15 (52%)	3	3	0	0	6 (21%)	2	3	1	0	6 (21%)	1	0	1	0	2 (7%)
Question 2c	8	8	4	2	22 (76%)	0	1	0	0	1 (3%)	0	1	0	0	1 (3%)	2	1	2	0	4 (17%)
Question 3	10	4	5	2	21 (72%)	0	5	0	0	5 (17%)	0	2	0	0	2 (7%)	0	0	1	0	1 (3%)
Question 4	5	7	5	1	18 (62%)	4	2	0	0	6 (21%)	1	1	1	1	4 (14%)	0	1	0	0	1 (3%)
Question 5	4	9	4	0	17 (59%)	4	1	0	1	6 (21%)	2	1	2	0	5 (17%)	0	0	0	1	1 (3%)
Question 6	8	10	5	1	24 (83%)	1	1	0	0	2 (7%)	1	0	0	1	2 (7%)	0	0	1	0	1 (3%)
Question 9	7	8	3	0	18 (62%)	1	1	1	1	4 (14%)	1	1	2	0	4 (14%)	1	1	0	1	3 (10%)
Question 10	7	5	3	1	16 (55%)	1	4	0	0	5 (17%)	2	1	3	1	7 (24%)	0	1	0	0	1 (3%)
Question 11	6	5	4	2	17 (59%)	3	4	1	0	8 (28%)	1	2	0	0	3 (10%)	0	0	1	0	1 (3%)

Table 2 tabulates a breakdown of the 29 stakeholder comment letters by level of agreement for eleven questions analyzed from the AICPA exposure draft 'Proposed Statement on Auditing Standards: Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement' (AICPA, 2020). Counts are presented in total (T, n = 29) as well as by category of respondent: Professional Organization (P, n = 10), Accounting Firm (F, n = 11), Governmental Organization/State Auditor (G, n = 6), or Academic/Other (A, n = 2). Responses categorized as "Partially Agree" reflect those respondents who agreed with the principle of the question conditional on further clarification of requirements or application materials. A response of N/A indicates a respondent's non-response to the indicated question. See Table 1 for the text of the questions analyzed.

Table 3: Stakeholder Response to AICPA Exposure Draft Questions - Perception of Clarity

Question	Sufficient Clarity					Needs Improvement					Unclear					N/A				
	P	F	G	A	T	P	F	G	A	T	P	F	G	A	T	P	F	G	A	T
	4	7	3	1		3	2	1	0		1	2	0	1		2	0	2	0	
Question 7					15 (52%)					6 (21%)					4 (14%)					4 (14%)
Question 8	7	6	4	1	18 (62%)	2	4	1	0	7 (24%)	0	1	0	0	1 (3%)	1	0	1	1	3 (10%)

Table 3 tabulates a breakdown of the 29 stakeholder comment letters by respondents' perception of clarity for two questions analyzed from the AICPA exposure draft 'Proposed Statement on Auditing Standards: Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement' (AICPA, 2020). Counts are presented in total (T, n = 29) as well as by category of respondent: Professional Organization (P, n = 10), Accounting Firm (F, n = 11), Governmental Organization/State Auditor (G, n = 6), or Academic/Other (A, n = 2). Responses categorized as "Needs Improvement" reflect those respondents who agreed with the principle of the question conditional on further clarification of requirements or application materials. A response of N/A indicates a respondent's non-response to the indicated question. See Table 1 for the text of the questions analyzed.

Among the respondents to Question 2a, 66% agreed that the components of a system of internal controls had been appropriately enhanced and clarified within the application materials. Those in agreement noted that the ASB had taken great care to define each component and explain why it was necessary to gain an understanding of each component. Of the seven respondents who partially agreed, each argued that the proposal adequately explained why auditors should gain an understanding of an entity's system of internal controls but was ambiguous regarding the methods auditors should use to achieve that understanding. These seven, along with the lone dissenter, suggested the inclusion of application materials or requirement steps that outline how auditors can achieve the required level of understanding. In response, the ASB further addressed the procedural aspects of gaining an understanding for each component of the entity's system of internal controls in the final SAS through expanded application materials that target the evaluation of each component. Question 2b had one of the lowest rates of approval with only 52% of respondents viewing the

proposed requirements and application materials pertaining to auditors' identification of controls addressing the risk of material misstatement as being enhanced and clarified. The remaining respondents who provided feedback to the question were evenly split between partial agreement (6 respondents, 21%) and disagreement (6 respondents, 21%). Two stakeholders elected to not provide feedback to this particular question. Both those in partial agreement and in disagreement took issue with the formatting of the proposed requirements, stating that they were difficult to understand. The exposure draft presented the requirements as a single standard paragraph broken into four parts, with each of those parts being further divided into multiple sub-sections that frequently referenced each other. Those who disagreed with the clarity of the proposed standard suggested for the ASB to include more direct language in the requirements and application materials for significant classes of transactions, as well as specifically define what other controls are being required. These dissenters argued that the current language in the exposure draft was open to wide interpretation that would be difficult to implement in cases of smaller audit firms and/or audits of smaller or less complex entities.

In response to the feedback received, the ASB made significant edits to the requirements and application materials for identifying controls that address the risk of material misstatement. While keeping the language intact, the ASB separated the single proposed requirement into five separate requirements, which improved readability. Additionally, the ASB modified the application materials to highlight the extent of requirements for identifying and testing controls that address relevant assertions. In particular, the ASB added paragraphs indicating that as long as at least one control is tested for each relevant assertion, not all controls need to be tested. Last but not least, the ASB also added several paragraphs to the application materials to define other controls and introduced further scalability materials that discuss the limitations that may be encountered in audits of less complex or smaller entities.

For Question 2c, 76% of respondents agreed that the proposed terminology and application materials allowed for consistent interpretation for audits of entities that used the COSO framework. Five respondents elected to forgo commenting on the proposal's compatibility with the COSO framework, and only one respondent expressed disagreement. The lone dissenter stated that because of clarity issues with Questions 2a and 2b, consistent interpretation was not feasible. As described above, the ASB made efforts to further clarify the requirements and applicable materials for understanding and assessing an entity's system of internal controls, which should also improve the consistent interpretation of the standard when applying the requirements to entities using the COSO framework.

It should also be noted that while four of the governmental organization/state auditors agreed with the proposal's compatibility with the COSO framework and the other two abstained from answering Question 2c, all six specifically referenced the U.S. Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* (the Green Book) in their response letters. The Green Book is the primary internal control framework utilized by governmental agencies. All six specifically suggested that the ASB include references to the Green Book framework in addition to COSO in the final SAS. These respondents argued that only referencing the COSO framework within the application materials limits the perceived adaptability of the standard for entities that utilize other control frameworks, and that referencing other frameworks, such as the Green Book, would allow for more efficient and effective integration of the updated requirements into future audits. In response to the suggestion, the ASB included references in its final standard to the GAO's Green Book within the application materials related to internal control systems and general IT controls. Regarding Question 3, 72% of respondents agreed with the notion that the requirements and application material related to understanding and assessing the client's IT environment and risks that arise from the use of IT were clear enough to support auditors' considerations of the effects of IT on the assessment of the risk of material misstatement. This positive response included all the professional organizations and academic/other respondents, but only about one third of accounting firm respondents. Accounting firm respondents made up all of those in partial agreement and disagreement with the posed question. Those in partial agreement understood the intention of the requirements and application

materials but indicated a lack of clarity concerning scope and scalability of the requirements between those pertaining to significant classes of transactions and other controls and those pertaining to assessing the client's IT environment. These respondents suggested that the ASB include requirements for gaining an understanding of and assessing direct controls over IT in conjunction with general IT controls when addressing risks arising from the use of IT. Both respondents who disagreed indicated a need for further clarification of the application materials and guidance relating to types of IT controls and scalability for understanding IT environments and IT controls in less complex business entities. In addressing these concerns, the ASB substantively edited Appendix E and Appendix F, both of which contain considerations for understanding IT and general IT controls, to improve applicability and clarity. In addition, in the final SAS, the ASB separated the requirements into their own paragraphs pertaining to assessing IT and the risks arising from the use of IT to improve readability. Question 8 sought feedback on the clarity of the requirements for evaluating the design and implementation of certain control activities. Sixty-two percent viewed the requirements as sufficiently clear. The seven respondents who suggested improvements argued that the clarity of the requirements was contingent upon improved clarification of the requirements and application materials defining other controls auditors should consider with respect to risks at the assertion level. As mentioned in the discussion of Question 2b, the ASB revised the final standard and provided greater detail in the application materials concerning other controls relevant to risk at the assertion level. The ASB also included more direct, procedural application materials for evaluating the design and implementation of control activities identified when addressing risks of material misstatement.

Identifying and Assessing Risk of Material Misstatement

Question 4 aimed to determine the level of respondents' support of new concepts and definitions concerning significant classes of transactions, account balances, disclosures, and relevant assertions, and asked whether there was sufficient guidance explaining how each is determined and assists in identifying where risks of material misstatement exist. Sixty-two percent of the respondents were in support of the new definitions and agreed that the proposal contained sufficient guidance. Twenty-one percent supported the new definitions but believed additional guidance was necessary to support the application of the new terms in identifying where risks of material misstatement exist. Fourteen percent of the respondents disagreed with the introduction of the new concepts and definitions, stating that new definitions further complicate the risk identification and assessment process. The ASB disagreed with the dissenters, keeping the new concepts and definitions in the final SAS, but did provide additional application materials to assist in guiding auditors in their determination and use in identifying where risks of material misstatement occur.

Regarding Question 5, 59% of the respondents fully supported the introduction of the spectrum of inherent risk, indicating that the concept helps establish a frame of reference for auditors as they assess an entity's inherent risk of material misstatement. Seven respondents partially agreed and suggested the use of a more explicit definition for the spectrum of inherent risk, requesting that the ASB provide examples of categories within the spectrum being identified. Respondents in disagreement with the introduction of the spectrum of inherent risk voiced concerns that the unclear definition in the proposal would lead to inconsistencies in practice which could further reduce audit quality across a given industry. Although a clear definition was not included in the key terms part of the requirements section, the ASB did expand the application materials regarding the spectrum of inherent risk in the final SAS and included examples for the classification of levels of inherent risk in each spectrum.

Question 6 had the highest rate of agreement out of all the request-for-comment questions, with 83% of respondents in support of requiring separate assessments for inherent risk and control risk in relation to all risks of material misstatements at the assertion level. The two respondents in disagreement argued that the decision to assess both inherent and control risk separately should be left up to professional judgement, while the two respondents in partial agreement raised concerns about consistency with requirements

prescribed by other SASs. The ASB elected to keep the separate assessment requirement in the final SAS but left the method of assessment up to the auditor's professional judgement.

Regarding Question 7, 52% of respondents viewed the requirements for assessing control risk to be sufficiently clear. Those respondents who viewed the requirement as being unclear voiced concerns about the ambiguity of language used in both the requirement and in the application materials, especially regarding the level of assessed control risk when controls are not being tested for operating effectiveness. Respondents requested that the ASB provide further application examples for completing the control risk assessment requirement proposed in the exposure draft. In response to respondent feedback, the ASB modified the requirement to explicitly require an assessed control risk of maximum when not planning to assess the operating effectiveness of controls. In addition, the ASB added additional examples into the application materials concerning levels of control risk and their implications on the reliability of controls and other audit procedures. For Question 9, 62% of respondents agreed with the revised definition and related application materials on the determination of significant risk. Four respondents expressed partial agreement for the revised definition and related materials, conditional on improving: 1) the definition of spectrum of inherent risk stated in the proposal; and 2) enhancing the relationship between the spectrum of inherent risk and the revised definitions of significant risks. The four respondents in disagreement viewed the introduction of the new concept of a spectrum of inherent risk alongside the new definition and application materials for significant risk as creating redundancy within the proposed standard. These respondents suggested that the ASB merge the two concepts within the application materials to enhance the clarity of both concepts and their relationship. In response to the stakeholder feedback, the ASB embedded additional content in the application materials for the definition of significant risks specifically indicating that significant risks are risks on the upper end of the spectrum of inherent risk and also added examples of sources of significant risks.

Stand-Back Procedure, Documentation, and Scalability

For Question 10, 55% of respondents agreed with the inclusion of a separate stand-back requirement related to the appropriateness of auditor determinations about material classes of transactions, account balances, or disclosures that had not been determined to be significant. Twenty-four percent of the respondents disagreed with the inclusion of the separate stand-back procedure, arguing that there are already sufficient requirements for auditors to step-back and reflect on the appropriateness of decisions made during the audit process. The respondents who partially agreed indicated that stand-back procedures are a necessary step in assuring audit quality and that a part of maintaining professional skepticism is reevaluating judgements made about what is and is not significant in the presence of acquired evidence. While these six respondents did not disagree with the addition of a separate stand-back requirement for the assessment of significant risks and risks of material misstatement, they viewed the application materials for this requirement to be vague on the nature of the requirement and how to satisfy it. Unfortunately, in the final SAS, the ASB provided no further clarification in response to stakeholder feedback for the stand-back requirement in the final SAS. For question 11, while 59% of the respondents agreed that the documentation requirements in the proposal were clear and appropriate, 28% partially agreed with the appropriateness but not with the clarity, especially regarding the scalability of the requirements. Three respondents indicated disagreement with both clarity and appropriateness and suggested that the ASB provide explicit examples and guidance for what should be documented to assure that the requirements have been met, especially regarding less complex and smaller entities for which available documentation of controls may be limited.

In response to stakeholder feedback, the ASB extended the application materials for the scalability of documentation and clarified that the minimum requirement is to enable an experienced auditor having no previous experience with the audit to understand the nature, timing, and extent of the risk assessment procedures performed. These minimum requirements include auditor conclusions made that result from risk

assessment procedures and the rationale for any judgements made. The ASB also provided clarification on the nature of documentation required for audits of less complex entities.

Finally, Question 1 asked respondents to comment on whether the proposed requirements and application materials could be applied to the audits of any entity regardless of size, complexity, or circumstance. This question was the only request-for-comment question that was answered by all respondents. Seventy-two percent of respondents agreed that the proposed SAS adequately addressed the issue of scalability, and 21% partially agreed on the condition that certain requirements be further clarified (these concerns are mentioned above in the discussion of questions 2b, 4, 5, 8, and 9). The two respondents who disagreed with the scalability took issue with the layout of scalability application materials being interspersed throughout the proposed SAS and the elimination of the "Considerations Specific to Smaller Entities" heading that had been intentionally removed by the ASB to focus on the complexity rather than the size of the entity as being the driving force for modifying audit procedures. The ASB took into account stakeholder feedback on scalability and made the requested changes to the application materials in the final standard.

A PATH FORWARD

Audit firms and private businesses must have governance structures that ensure high quality audits. Those in leadership positions must promote a system of quality management that emphasizes education and training, appropriate rewards, whistleblower policies, processes that eliminate non-compliance with policies, and ethical values. In addition, these systems must facilitate the understanding of an entity's environment and assessment of the risk of material misstatement in financial information. To ensure the proper application of these concepts in practice, professional standards and supporting materials must be unambiguous in defining these concepts and establishing how they are properly applied. The analysis of the proposal, constituent feedback, and the final standard demonstrates that the AICPA clearly emphasized the importance of understanding an entity's environment and assessing the risk of material misstatement in financial information and clarified those concepts and the manner of their implementation in financial audits. In addition, the AICPA was responsive to a vast majority of constituent feedback, disagreeing with them in only three respects. In our opinion, the AICPA was justified in keeping new concepts and definitions concerning significant classes of transactions, account balances, disclosures, and relevant assertions in the final standard. However, we believe that a clear definition for the spectrum of inherent risk should have been added to the inventory of key terms and concepts. Finally, we agree with the decision of leaving the assessment of inherent risk and control risk as separate tests. The AICPA will have further opportunities to revise the code and create materials that include the definition of the spectrum of inherent risk. At the same time, all stakeholders play a role in facilitating the proper implementation of *SAS No. 145*. In the following paragraphs, we explore other aspects that may assist auditors in this quest.

First, regulators, educators, and professionals must collaborate to develop applied guidance to implement *SAS No. 145*. In public and private organizations, boards of directors and audit committees can help auditors understand the entity's control environment, assess different types and levels of risk, and support them in their pursuit to gather appropriate and sufficient evidence that is persuasive to render an opinion. Board and committee members may ask probing questions during meetings and not shy away from disagreeing with management. Directors and committee members should be educated in the areas of IT controls and major areas of risk, along with accounting, auditing, technology, and financial practices. All stakeholders must understand that while different types of risks and levels of risk can be documented, it is difficult to document how these decisions were reached until they are manifested in the results of actions. It is unavoidable that the amount of time and effort dedicated to documentation will increase as auditors document actions taken, types of risks evaluated, the level of risk assigned to each type of risk, the nature of critical evidence underlying these decisions, and the decisions made to expand, reduce, or leave unchanged the nature, timing, and extent of procedures needed during the course of an audit. Since professional judgment in identifying areas of risk and assessing levels of risk occurs in the mind and is not directly observable, it is

important to include in the documentation a description of how the auditor overcame certain biases in forming their judgments and conclusions. Training professionals to document how professional judgment was exercised in making decisions and the level of professional skepticism applied in assessing risks will be difficult. Gissel (2018) describes the types of training best suited for audit professionals, which include mentoring by senior auditors, seminars and workshops, other continuing professional education, and cases that use actual audit information. While the education of professional accountants starts with academia and standard setters, training flows from professional firms. To properly implement *SAS No. 145* in audit practice, curricula of both undergraduate and graduate accounting programs must include updated topics of UEE and ARMM. In addition, there should be training in workplace settings. Both Brown-Liburd (2017) and Gissel (2018) show that applied practice of new audit concepts in varied situations is needed in both academic and professional audit classrooms in order to build the skills and abilities required by new standards. In addition, as recommended by Hayes (2016), direct classroom instruction on obtaining an understanding of the control environment and assessing the types and levels of risk better prepares students to be skilled professionals. One approach that can aid auditors in being more skeptical in assessing levels of risk and being less subject to biases is to train them to analyze a given situation from multiple perspectives. A multi-perspective analysis can be particularly useful for determining the types and quantity of evidence needed given a particular level of risk and for ensuring the consideration of both confirming and disconfirming evidence. In summary, stakeholders are asking for additional training and support aimed at clarifying an auditor's UEE and assessment of RMM. Auditors need direction to ensure that their documentation of audit decisions made when evaluating IT controls and assessing RMM will be acceptable during regulatory inspections and peer reviews. Stakeholders also want clarification on the definition of the spectrum of inherent risk introduced in the new audit standard as a needed step in the path forward. New education and training materials and research are needed to support auditors' implementation of *SAS No. 145.* This need provides an excellent opportunity for the AICPA, audit firms, and academics to work together and develop implementation examples and other material demonstrating the best practices in evaluating the IT environment and controls, and in assessing various types and levels of risk. Thankfully, the professional, academic, and business accounting environments have a long history of cooperation in such matters that will meet this challenge.

CONCLUDING COMMENTS

This paper presents an overview of *SAS No. 145* that enhances and clarifies the audit standards on obtaining an understanding of the business entity's control environment and assessing the risks of material misstatement. The comment letters submitted by stakeholders during the exposure draft stage of the standard setting process were examined. Respondent perspectives on the clarity and enhancement of the standard requirements were assessed by analyzing the stakeholder responses to the 13 request-for-comment questions by level of agreement (i.e., Agree, Partially Agree, and Disagree for questions 1 – 6 and 9 – 11; and Sufficient Clarity, Needs Improvement, and Unclear, for questions 7 and 8). These responses were tabulated by respondent entity type (Professional Organization, Accounting Firm, Governmental Auditor, or Academic/Other), as well as by agreement across all respondent types. Stakeholder comment letters were analyzed and based on stakeholder feedback, the exposure draft was compared to the final standard issued to assess the impact respondent input had on the final standard issued. While our findings suggest general stakeholder support for the proposed enhancements to the standards, nearly all respondents provided recommendations for further clarification. Our comparisons of the drafted proposal and final standard indicate a high degree of responsiveness on the AICPA's part in addressing the respondents' concerns regarding needed clarifications and enhancements. However, the AICPA was not responsive to respondent concerns about the application of the spectrum of inherent risk. The AICPA could address these concerns by issuing additional authoritative guidance for assessing inherent risk based on the concept of a spectrum of inherent risk, and by providing case studies and reference materials to properly implement the changes introduced in the standard. The generalization of our results is subject to certain limitations. As commentary on stakeholder clarity and reception of the exposure draft, this study is limited by the number of response

letters submitted to the ASB and the type of stakeholders who chose to respond to the AICPA's request for comment. The AICPA comment period was limited to three months – September through November of 2020 – during which time the AICPA received a total of 33 comment letters. The length of the exposure draft and the short response period may have been contributing factors for the limited number of respondents. In addition, the analysis in this study is limited by the questions posed by the AICPA in its request for comments. Thus, some of the requirements and application materials within the proposed standard may not have been addressed in the comment letters. Moreover, given that the AICPA's standard setting process and its procedures involved in developing and issuing new standards are not completely observable to the public, it is highly likely that the AICPA utilized inputs from sources other than stakeholder response letters when it revised the proposed requirements and issued the final standard. Taking into account the ever-evolving nature of information technology, further inquiry is needed to examine the effects of IT on the risk of material misstatement and its potential as a useful control device for the detection of misstatement. These further inquiries should focus on both the entity's use of IT in its control environment, and the auditor's use of IT applications in conducting risk assessments and other audit procedures. Additionally, with the introduction of new terminology and concepts regarding inherent risk, research into the establishment of a more explicit model for the spectrum of inherent risk may prove beneficial to ensure efficient and effective application of this new concept in future audits.

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