Cotton& Company
Answers Questioned

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Auditing Standards Board
American Institute of Certified Public Accountants
New York, NY
CommentLetters@aicpa-cima.com

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

Ladies and Gentlemen:

Cotton & Company commends the Auditing Standards Board (Board) for addressing this topic and proposing improvements to this standard. In particular, we agree with recognizing the importance of information technology (IT) general controls and the use of the computer as an audit tool, adding guidance on direct vs. indirect controls, requiring a separate evaluation of inherent risk, and other clarifications. However, we suggest that the Board further enhance the standard in the following ways:

Reduce Size of Standard
At more than 200 pages, the exposure draft is far too large for the average practitioner to quickly and easily understand. We suggest the following to help practitioners more easily understand the standard:

- Move the appendices and most of the application material to the audit guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit.* Practitioners will understand the standard more easily because the audit guide uses a case study approach. The Board should issue the revised audit guide at same time as the revised AU-C 315. The application guidance in AU-C 315 should refer to the guide.
- Divide the single standard into two separate standards, consisting of the following:
  1. Understanding the entity and its environment.
  2. Assessing the risks of material misstatement.

  This will shorten both standards, making them both easier to understand.

Enhance the Guidance Concerning Inherent Risk
Although we support the requirement for a separate evaluation of inherent risk, we believe that the Board should enhance the standard in the following ways:

- Be clear that the auditor should evaluate ***inherent risk*** before evaluating control risk. Evaluating inherent risk helps the auditor determine what could go wrong if there were no controls. Auditors should use the results of the assessment of inherent risk to identify controls that will prevent or detect these misstatements and to focus their evaluation of the design and effectiveness of internal control. We therefore recommend that the Board move the discussion of inherent risk assessment in paragraphs 31 through 33 after paragraph 20.

- Clarify that auditors should assess the direction of inherent risk. Are the incentives such that misstatements are likely to be overstatement or understatement of income? This will help the auditor determine the inherent risk by assertion.
- Clarify that auditors should assess inherent risk at the financial statement level and at the account and assertion level. This will help the auditor assess the risk of material misstatement at these levels.
- Clarify that when inherent risk is low, the auditor is not required to obtain a detailed understanding or perform tests of controls. Low inherent risk means that—even if there were no controls—there would be only a low risk of material misstatement. If there is low inherent risk, the entity probably does not need controls to prevent or detect material misstatements.

Further Clarify the Meaning of Significant Risk

Although we believe the revised definition is clearer than the current definition, further clarification is necessary. We suggest the following:

- Change the term "significant risk" to "significant inherent risk." This will remind auditors that the concept refers to an inherent risk, not a significant risk of material misstatement. The standard should also define "significant risk of material misstatement" as a very high risk of material misstatement. All standards should be evaluated to determine which term is appropriate (see below).
- Include in the standard that significant inherent risk becomes a significant risk of material misstatement only if the entity has not designed sufficient controls to overcome this risk. For example, inventory pricing might be a highly complex calculation, causing the auditor to decide this is a significant inherent risk. However, the entity may have designed and effectively implemented controls over this calculation. If the auditor has understood and tested those controls, this would ***not*** be a significant risk of material misstatement. (This process is similar to the auditor's process when evaluating any inherent risk.) Ultimately, the auditor's objective is to identify significant risk of material misstatement rather than significant inherent risk.
- Eliminate the term "spectrum of inherent risk," as this is not a common term and could be easily misunderstood. Instead, focus the definition of "significant inherent risk" on likelihood and materiality. Thus, a revised definition would be "Significant inherent risk is a very high inherent risk (i.e., the risk that if there were no controls, there would be a high probability of a material misstatement) or a situation where if there were no controls a misstatement several times planning materiality could occur."
- Make conforming changes to other standards to clarify whether "significant risk" refers to a significant inherent risk or a significant risk of material misstatement. For example, when the standards require the auditor to communicate with those charged with governance regarding significant risks, should the auditor communicate significant inherent risks, or significant

risks of material misstatement? Cotton & Company believes that the standards should refer to the latter, but based on the current phrasing, an auditor might think it is the former.

- Clarify whether the reporting of "key audit matters" relates to ***significant inherent risk*** or ***significant risk of material misstatement***. (Again, we believe it should be the latter.)
- Clarify AU-C 240. It is unclear whether AU-C 240 refers to fraud risk as a significant inherent risk or a significant risk of material misstatement. For instance, AU-C 240.26 includes the following language: "Based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks." This phrase appears to refer to inherent risk; however, the standard does not specify such. Accordingly, the Board should clarify this section.
- Clarify AU-C 240.27, which states, "The auditor should treat those assessed risks of material misstatement due to fraud as significant risks." Because the auditor assesses the risks of material misstatement after considering controls, risks of material misstatement in this section cannot be inherent risks. Accordingly, the Board should clarify this section.
- Clarify whether all fraud risk is a significant inherent risk, or whether management override of controls is the only significant inherent risk related to fraud. If the latter, it would be more appropriate to view management override risk as a control risk, not an inherent risk. The Board should either integrate AU-C 240 into AU-C 315 or write AU-C 240 such that it differentiates "significant inherent risk" from "significant risk of material misstatement."

Integrate AU-C 940 into AU-C 315

AU-C 940 and AU-C 315 both deal with internal control; however, they use different approaches and terminology. We believe that consistent approaches and terminology will help the auditor better understand both standards. We suggest the following:

- Use the same terminology in both sections. For example, use "internal control over financial reporting" rather than "system of internal control" and use "entity-level controls" rather than "indirect controls."
- Indicate that, in order to give an opinion on controls, the auditor should perform the same analysis of inherent risk and design of internal control. The only difference should be that an opinion on controls requires the auditor to perform tests of controls, while an opinion on the financial statements ***does not*** require the auditor to perform tests of controls.
- Consider combining much of the material in AU-C 940 into AU-C 315. For example, material such as the standards on top-down approach, understanding how the components of internal control are integrated, understanding the controls over the year-end closing process, understanding likely misstatements, and benchmarking of automated controls applies to a financial statement audit and therefore belongs in AU-C 315.
- Include the application guidance in AU-C 940 in AU-C 315 or in the audit guide, as it also applies to financial statement audits. This would include the guidance on the importance of walkthrough procedures, the guidance on the control environment, and the guidance on the other elements of internal control.
- Move the following definitions and concepts from AU-C 940 to AU-C 315:
    - Control objective

- Preventive control
- Detective control

Clarify Internal Control Concepts
To help the practitioner better understand internal control concepts, we suggest the following changes:

- Do not change the term "internal control" to "system of internal control." "Internal control" is a well-understood term and has been adequately defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). As there does not appear to be a benefit to changing the terminology, we suggest not changing this term.
- Split "information system" from "communication." Although we agree with the concept of direct vs. indirect controls, this split is necessary because the information system usually contains direct controls, while communication is an indirect control.
- Clarify that most monitoring is usually a direct control. For example, a bank reconciliation is usually both a monitoring control and a direct control over cash.

We thank you for the opportunity to comment on this exposure draft.

Sincerely,

Alan Rosent

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