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September 16, 2020

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Technical Director
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Via IAASB website at www.iaasb.org

Re: Invitation to Comment: Enhancing Audit Quality in the Public Interest – A Focus on Professional Skepticism, Quality Control and Group Audits

Thank you for the opportunity to comment on the proposed update to International Standard 600. Your open process and public webinars have been helpful and informative.

I believe the proposed changes will improve practice and clarify existing practice issues.

My comments apply primarily to the risk-sensitive planning of group audits and the selection of some components for auditing when all components are not subject to detailed audit procedures. I believe they relate primarily to issue GA7, Responding to Identified Risks of Material Misstatement in a Group Audit (Including Issues Relating to the Group Engagement Team’s Involvement in the Consolidation Process).

An issue I have repeatedly seen in workpapers and as a consultant and advisor is that for many engagements, auditors are unable to provide any explanation of the factors they considered when setting the scope of the components to be audited in a group. Peer reviewers and inspectors challenge the auditors to support that sufficient evidence has been gathered to attain a low audit risk. Why they chose a certain number of components to apply procedures rather than more or fewer is often entirely unclear.

While in some entities, centralized management and control support an aggregate audit approach across components. There remain numerous situations where this structure does not apply. Nevertheless, some auditors incorrectly “shoehorn” their audit strategy into this mold for ease of design

and performance of procedures. One issue contributing to this incorrect practice is the lack of guidance, structure and examples in the extant Standard when setting the scope on multi-component audits.

In addition, I note the current ED does discuss scoping in the A appendix section (*Scoping a group audit*: paragraphs A86 – A90). However, that specific guidance is limited to entities with a homogeneous controls and operating environment across components. While this may address the current direction of many entities toward shared services and processes, it does not represent the current situation for many smaller to medium enterprises where the business model for its components may not yet be mature enough to impose a firm-wide internal control and central record-keeping process.

Since the issuance and implementation of the Group Audits Standard there have been some publications that recognize and illustrate some methods for addressing this problem. In the research and accounting literature there have been several efforts to provide some structure and guidance around the scoping of component audits. In 2008, the AICPA published an updated Audit Guide *Audit Sampling*. The Task Force for this guide agreed to include an Appendix illustrating a two-step process for multiple component audit planning. This suggested approach could be applied when component environments were not sufficiently homogeneous to treat them as one population, and not all significant components will be subject to auditing procedures. Now Appendix L in the latest (2019) update to that guide, the illustrated process included a decision about how many components would be examined and secondly, the scope of audit procedures to be applied at those locations to achieve a low group audit risk. Before and after this publication, the approach in the guide was applied in several large and medium size US firms. In practice, at least one firm developed an Excel template to facilitate practice use of the approach.

The need for illustrations of applying this approach for others to better understand how to operationalize the concepts was realized with the 2017 publication in the International Journal of Auditing (IJA) of a paper entitled *Managing Group Audit Risk in a Multicomponent Audit Setting*. A practitioner summary of that paper was subsequently published in the American Accounting Association's Current Issues in Auditing, Fall 2018. The IJA paper provided specific examples of how the approach outlined in the guide could be applied under various different assumptions regarding the characteristics of the components. A key value of the illustration of the approach in the IJA paper was the articulation of the factors involved in the scoping decision and how each of those factors contributed to the planning decisions.

In 2008 the *Journal of Accountancy* (US) published a practice-oriented paper entitled Component Materiality for Group Audits. The approach in this paper was to allocate group materiality to major components that would be receiving auditing procedures. It was assumed that components not receiving audit procedures were of lesser value such that analytical procedures would provide sufficient evidence. While helpful in the circumstance where a few major components comprised the entity, the more difficult problem of how many components should be selected for the application of audit procedures was not addressed. However, these two approaches are not mutually exclusive, but can be applied together.

I urge the Committee to consider for inclusion in its scoping guidance at least some of the factors and structure identified in these studies for auditor consideration when faced with planning engagements where the components cannot logically be considered as a single unit. While short of specifying a methodology for application in planning, like in Section 530 on Audit Sampling, the factors for

consideration when setting a sample size (e.g., risk, tolerable misstatement, expected misstatement) help structure and document the decision.

Amongst the important factors outlined in the aforementioned papers are:

The overall assessment of organization centralization and internal control over financial reporting effectiveness of the entity. Do the individual component characteristics support their treatment as a homogeneous audit unit from the perspective of risks, controls, organizational and the centralization of accounting records, management oversight and accounting software and financial reporting policies?

Determining a logical component base or bases (e.g., assets, revenues, contribution to entity profitability) from which to plan and allocate the audit effort required. It may be appropriate to consider the relative impact on planning of several relevant bases.

The identification of components for examination that due to their size or assessed risks should clearly be selected and have audit procedures applied. If, after the identification of these components, the number and value of the remaining locations is still significant in the aggregate, decisions regarding the number of components to be selected for applying procedures will need to be made.

The identification of trivial components for the application of limited auditing or analytical procedures.

When components are numerous and a few large components cannot be identified to comprise the entity, then selections of components and scoping decisions about the components where audit procedures will be applied may follow the general risk structure outlined in Appendix L of the 2019 AICPA Audit Guide *Audit Sampling*.

Factors entering into the decision about the minimum number of components to be identified for applying audit procedures may include:

- The magnitude of the selected base(s) of each component
- The assessed maximum misstatement of the base(s) at a component that could exist and not be detected by entity controls or other applied auditing procedures. If not able to be limited, then a conservative assumption could be that a 100% misstatement could exist.
- The minimum number of components in the remaining population (after removal of the large and risky components) that would have to be misstated to the “worst case” extent to cause a group misstatement concern. This could result in the number of components necessary to select in order to detect if the “worst case” assumption might exist in the population of remaining components.
- The scope of auditing procedures needed at the selected components where audit procedures are to be applied to detect existence of a possible “worst case” condition and also meet component performance materiality requirements.

The practitioner summary article in the *Current Issues in Auditing* article contained the following table which has been found to be helpful guidance:

Factor	Effect on Calculation	Result
Larger components remain in the population to be sampled.	Fewer components need to contain the critical event to reach the threshold.	More components will need to be audited.
Critical-event assumptions are less conservative: a lower “worst case” misstatement proportion can be supported.	More components will need to contain the critical event to reach the threshold.	Fewer components will need to be audited.
Trivial components exist (absent a risk of material understatement).	Fewer components will exist in the population.	Fewer components will need to be audited. Trivial components may be more efficiently examined with analytical procedures and occasional verification.

As noted in paragraph A91 in the ED, an element of unpredictability remains important in fraud prevention and protection.

I would be pleased to assist the Task Force in any way in refining this suggestion to assist practice in making more effective and more consistent scoping decisions when the existence of multiple components create scoping complications.

References:

Association of International Certified Public Accountants. (2019). *Audit Guide: Audit Sampling*. New York, AICPA. Note: Appendix L of this guide was originally published in the 2008 version of the Guide and has been carried forward to subsequent editions.

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Respectfully submitted,



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