



Chapter 1

AICPA Activities

Learning objectives

- Identify the requirements of recently issued Statements on Auditing Standards (SASs).
- Identify common audit deficiencies found by the AICPA.

The AICPA's Center for Plain English (CPEA) is available to AICPA members that are also members of the Firm Practice Management section (PCPS). The AICPA intends the CPEA to act as a "national office" for small- and medium-sized CPA firms providing accounting and auditing services.

Recently issued auditing and attestation standards

Overview

The Auditing Standards Board (ASB) has recently issued the following SASs and Statements on Standards for Attestation Engagements (SSAEs):

- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*
 - SAS No. 135, *Omnibus Statement of Auditing Standards – 2019*
 - SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* (due to nature of topic this will not be addressed in this course)
 - SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*
 - SAS No. 138, *Amendments to the Description of the Concept of Materiality*
 - SSAE No. 19, *Agreed-Upon Procedures Engagements*
 - SSAE No. 20, *Amendments to the Description of the Concept of Materiality*
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Statements on Auditing Standards

SAS No. 134

Background

SAS No. 134 contains the following four sections:

- AU-C section¹ 700, *Forming an Opinion and Reporting on Financial Statements*
- AU-C section 701 (new), *Communicating Key Audit Matters in the Independent Auditor's Report*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*

The ASB considered other standard setters, including the IAASB and PCAOB, in updating the auditor's report. In sticking to its goal of convergence where possible, the ASB decided to converge with the IAASB auditor's report model. Because both the IAASB and PCAOB made formatting changes, the AICPA made changes to the auditor's report to be consistent with changes made with other standard setters.

In keeping with its strategy of convergence, the ASB has considered the revisions to the auditor's report resulting from the IAASB and PCAOB auditor reporting projects in developing the changes to generally accepted auditing standards (GAAS) in SAS No. 134. The ASB believes these changes will increase the

¹ All AU-C sections can be found in AICPA *Professional Standards*.

informational value and relevance of the auditor's report for users and, therefore, are in the public interest.

Feedback from user groups informed the changes to the auditor's report. Many users like the current pass-fail model. However, users also indicated that they would appreciate more information about significant aspects of audit procedures and results. Feedback indicated that providing audit specific information would be valuable to users by adding transparency into the audit process.

The following AU-C sections are being superseded:

- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*, as amended
- AU-C section 706, *Modifications to the Opinion in the Independent Auditor's Report*

As previously mentioned, a new section is being created: AU-C section 701.

Each section of SAS No. 134 is effective for audits of financial statements for periods ending on or after December 15, 2020. Early implementation is **not** permitted.

AU-C section 700, Forming an opinion and reporting on financial statements

Format

Most users of the audit report will notice that the report has been reorganized. The first header in the new report will be the “Opinion” header. The opinion section will be followed by a “Basis of Opinion” section. Prior to this standard, a basis of opinion paragraph was only added when there was a modification to the opinion. Going forward, all reports will contain a basis of opinion paragraph.

Opinion:

The “Opinion” section starts with the same opening paragraph as previously; auditors will continue to identify the client, the financial statements, and the dates under audit. The second paragraph in the opinion section will present the opinion. The content of this paragraph has not been modified by the new guidance.

The objective of the change is to help the user understand the financial statements better by first stating the conclusion and then explaining how the auditor got there.

Report on the audit of the financial statements²

Opinion

We have audited the financial statements of XYZ Not-for-Profit Organization, which comprise the statements of financial position as of December 31, 20X1 and 20X0, and the related statements of activities and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of December 31, 20X1 and 20X0, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for opinion

The next section is the “Basis for Opinion” paragraph. The paragraph begins with the same sentence currently in the “Auditor’s Responsibility” paragraph indicating that the audit was conducted in accordance with GAAS. After this sentence, two new statements have been added. The first addresses the auditor’s responsibilities and refers readers to that section. The other is an explicit statement regarding independence and ethics. Previously, the only mention of independence in the auditor’s report was in the report title.

² The subtitle “Report on the Audit of the Financial Statements” is unnecessary in circumstances in which the second subtitle, “Report on Other Legal and Regulatory Requirements,” is not applicable.

Basis for opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of XYZ Not-for-Profit Organization and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Although the "Opinion" section is required to be first in the report, followed by the "Basis of Opinion" section, the new report otherwise provides a lot of flexibility in the reporting and order of paragraphs. This course covers the basic paragraphs. However, "Emphasis-of-Matter," "Other-Matter," and "Key Audit Matters" paragraphs have flexibility in placement and prioritization.

Responsibilities of management

The next section is the "Responsibilities of Management for the Financial Statements" paragraph in a report with no modifications, key audit matters (KAM) or emphasis paragraphs. The section includes much of the current language for management including responsibility for preparation and fair presentation as well as design, implementation, and maintenance of internal controls. There is an added focus, however, on management's responsibility to evaluate the entity's ability to continue as a going concern when that is required by the financial reporting framework used by the client.

Responsibilities of management and those charged with governance for the financial statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Not-for-Profit Organization ability to continue as a going concern for *[insert the time period set by the applicable financial reporting framework]*.

Auditor's responsibilities

The next section highlights the auditor's responsibilities for an audit. Significantly expanded, this section walks the users through the process of performing an audit from start to finish. In lieu of focus on responsibilities the way the prior report format did, the new report focuses on the auditor's objectives similar to the language used in the SAS. The opening paragraph adds a definition of reasonable assurance as well as of material misstatement; this is to assist the users of the financial statements with

interpreting the language used to explain the role of the auditor. The report also discusses the use of professional judgment and professional skepticism.

The largest portion of this section focuses the reader on the process of performing an audit. It explains the role of risk assessment (see AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*), response to risk (see AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*), and audit evidence (see AU-C section 500, *Audit Evidence*). The section also addresses the fact that fraud is harder to detect than material misstatement. The standard calls attention to issues like collusion and override of internal controls that limit the effectiveness of internal controls and make it harder for auditors to find fraud. Also covered is the role of internal controls with similar language that has been used by auditors to communicate a focus on obtaining an understanding of internal control to enable the design of appropriate procedures. It also addresses the responsibilities for estimate made by management similar to the current auditor's report. There is new language regarding going concern depending on the financial reporting framework used. Finally, the section addresses communications with those charged with governance. The section uses bullet points as a means of communicating the various responsibilities.

Note: SAS No. 138 updates the definition of materiality. As such, this section was updated to reflect the updated definition.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.

Auditor's responsibilities for the audit of the financial statements (continued)

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of XYZ Not-for-Profit Organization's internal control. Accordingly, no such opinion is expressed.³
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Not-for-Profit Organization's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control related matters that we identified during the audit.

Now that the "Opinion" section has been moved to the top of the report, the final required paragraph would be the "Auditor's Responsibilities for the Audit of the Financial Statements" section. If the auditor has any other reporting responsibilities for the engagement, this would be disclosed directly after the "Auditor's Responsibilities" section in the "Report on Other Legal and Regulatory Requirements" section. The signature of the auditor, the city and state, and the date of the report would then appear at the bottom.

See an example auditor's report in appendix B of this chapter.

Knowledge check

1. What is the first section heading in the new auditor's report?
 - a. Opinion.
 - b. Basis for Opinion.
 - c. Management's Responsibilities.
 - d. Auditor's Responsibilities for the Audit of the Financial Statements.

AU-C section 701, Communicating key audit matters in the Independent Auditor's Report

AU-C section 701 introduces the concept of key audit matters (KAM). The IAASB requires the reporting of KAM for listed entities (comparable to issuers in the United States) and PCAOB has a similar concept called critical audit matters that is required. The AICPA decided not to require the communication of KAM for all entities. Instead, the auditor is only required to report KAM if they are specifically engaged to

³ In circumstances in which the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of XYZ Not-for-Profit Organization's internal control. Accordingly, no such opinion is expressed."

communicate KAM. Potential reasons an auditor may be engaged to report KAM include requirements by regulators, banks, or parent companies who request KAM. When the auditor is engaged to communicate KAM, the auditor is required to apply AU-C section 701.

Definition:

Key audit matters, or KAM are those matters that, in the auditor's **professional judgment**, were of **most significance** in the audit of the financial statements of the **current period**. Key audit matters are selected from matters **communicated with those charged with governance**.

The scope of KAM guidance applies only to audits of complete sets of general-purpose financial statements. Auditors are prohibited from reporting KAM when issuing an adverse or disclaimer of opinion, unless the reporting is required by law or regulation.

As noted in the definition, KAM are matters that were of most significance in the audit. Significance is typically considered by using a risk based approach to auditing. Typically, the higher the risk, the more attention is given in planning and the more extensive the required procedures. Significant risks that require special audit responses would likely be considered for determination as to whether they required significant attention. However, not all significant risks are KAM. Auditors will need to identify areas that posed challenges during the audit and perhaps required consultation or the use of a specialist. Other areas, such as estimates with high estimation uncertainty and related party transactions, are also considerations for KAM.

The population for KAM selection is topics that were **communicated to those charged with governance**. AU-C section 260, *Auditor's Communication With Those Charged With Governance*, requires communication of significant difficulties encountered during the audit, related party transactions, and matters related to group audits. AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, provides required communication regarding consultation on difficult or contentious matters and AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*, provides guidance on communicating internal control deficiencies.

The population for KAM could potentially be quite large. However, the auditor is required to select those that are of the "most significance" which requires the auditor to rank the items. Considerations include the importance to users, the nature of underlying accounting policy, nature and materiality of corrected and uncorrected misstatements, nature and extent of audit effort, nature and severity of difficulties in applying audit procedures, and severity of control deficiencies in trying to determine a relative significance. The largest area of professional judgement is determining ultimately what and how many were most significant. The number of items ultimately determined to be KAM is affected by size and complexity of entity, nature of business and environment, and facts and circumstances of audit engagement.

Once KAM is identified, there will be a separate section of the auditor's report with a heading titled, "Key Audit Matters." The section starts with a required introductory paragraph to introduce the concept of KAM and how KAM fits in with the overall audit's objectives.

“Key audit matters are those matters that were communicated with those charged with governance and, in the auditor’s professional judgment, were of most significance in the audit of the financial statements [of the current period]. These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor’s opinion thereon, and the auditor does not provide a separate opinion on these matters.”

In the following paragraphs within the section, the auditor describes each KAM, includes a reference to related disclosures as appropriate, and describes why the matter was considered to be one of the most significant in the audit. In addition, the auditor discloses how the matter was addressed in the audit. The auditor, using professional judgment, determines the amount of detail. Examples of how to describe how the matter was addressed may include an overview of procedures performed and/or an indication of the outcome of procedures (without implying a discrete opinion on separate elements of the financial statements). The goal is to meet financial statement user needs by providing entity specific information that is not overly standardized or boilerplate.

Laws and regulations could potentially preclude the disclosure of a particular matter. Similar to Yellow Book, the auditor would have to determine the appropriate response. Auditors also determine whether any adverse consequences of reporting the matter would reasonably be expected to outweigh public interest benefits of such communication, keeping in mind the goal of KAM is transparency. Management’s views about adverse consequences do not alleviate the need for auditor determined cost-benefit analysis.

The following items are required documentation items:

- The matters that required significant auditor attention
- Rationale for whether or not each of the matters is a KAM
- Reason a KAM was not communicated in auditor’s report

Auditors are not required to document why other matters communicated with those charged with governance were not matters that required significant auditor attention.

AU-C section 705, Modifications to the Opinion in the Independent Auditor’s Report

AU-C section 705 provides examples of audit reports when modifying the auditor’s opinion. When issuing a qualified opinion, a second paragraph is added to the basis for opinion section providing an explanation of the cause of the modification. This is similar to the use of the basis paragraph prior to SAS No. 134. A similar paragraph is added when providing an adverse opinion. However, a disclaimer opinion looks very unique. The standard continues to use the concept of “we were engaged” instead of “we have audited.” The second paragraph continues to indicate “we do not express an opinion.” However, the standard basis of opinion paragraph is removed and only the paragraph related to the reason for disclaiming an opinion is reported. In addition, the auditor’s responsibility paragraph is shortened to two paragraphs. The first is a very shortened discussion of the auditor’s responsibilities. The second and final sentence in the first paragraph explains that because of the item described in the basis paragraph the auditor did not obtain sufficient appropriate evidence. The verbiage about reasonable assurance, material misstatement etc. are removed from the paragraph. The bulleted list of audit procedures is also removed. Instead the

section closes with the statement of independence normally found in the basis paragraph. A user will easily be able to determine that this is not a normal clean opinion just from the length of the report.

AU-C section 706, Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report

AU-C section 706 addresses emphasis of matter and other matter paragraphs. Both definitions are updated to describe the interplay with the concept of KAM. The section also provides guidance on placement of EOM and OM paragraphs and their interaction with KAM paragraphs. Reporting on annual reports and going concern paragraphs are no longer deemed to be emphasis or other matter paragraphs. Instead they are separate sections under SAS No. 134.

Knowledge check

2. When issuing a qualified opinion, how many paragraphs would the basis for opinion paragraph have?
- a. 0
 - b. 1
 - c. 2
 - d. 3

Other Changes

While the focus of SAS No. 134 is the changes to the auditor's report, there are also two other types of changes – conforming amendments and changes made due to the disclosure project. As evidenced by the title, one of the biggest areas of focus outside of the report was the consideration of the auditor of disclosures throughout the audit. The standard moves the terminology towards the use of disclosures instead of the term notes. Changes to AU-C 200 provides more guidance on what is a disclosure and its purpose. AU-C 210 is also updated to include changes to the engagement letter to reflect the new report language. AU-C 240 includes a focus on the consideration of fraud to note disclosures and adds that omitting, obscuring, or misstating disclosures is a characteristic of fraud. In the discussion among team members, the standard adds a discussion regarding disclosures that obscure understanding by being unclear or ambiguous. AU-C 260 adds communications regarding significant risks during the planning phase and includes additional communication considerations for communication with those charged with governance. AU-C 300 focuses on the audit plan related to disclosures while adding considerations in planning regarding disclosures. AU-C 315 incorporates additional risk assessment considerations for disclosures. Another key change is that assertions related to presentation and disclosures were removed and instead incorporated at the account balance and class of transaction level. AU-C 330 addresses misstatements related to inappropriate classification and omissions of disclosures. AU-C 600 provides updated reporting for group audits. As a result, auditors should carefully review checklists, audit programs and communications to ensure compliance when adopting SAS No. 134.

Future changes

The AICPA has issued multiple exposure drafts to update all sections impacted by the audit report changes. This includes *Proposed Statement on Auditing Standards, Amendments to AU-C sections 800, 805, and 810 to Incorporate Auditor Reporting Changes From SAS No. 134* and *Proposed Statement on Auditing Standards, Amendments to AU-C sections 725, 730, 930, 935, and 940*. As of January 2020, these changes were in the proposal phase.

You are encouraged to monitor the changes to these sections at aicpa.org.

Knowledge check

3. AU-C section 701 introduces what new section of the audit report?
 - a. Key audit matters.
 - b. Critical audit matters.
 - c. Significant audit matters.
 - d. Crucial audit matters.

SAS No. 135

SAS No. 135 was issued in April 2019 and is effective for audits of financial statements for periods ending on or after December 15, 2020.

When the AICPA last overhauled the audit standards back in 2012 as part of the Clarity Project, the focus was on convergence with the IAASB, but also considered were opportunities to converge with the PCAOB. Since the Clarity Standards, the PCAOB has issued the following:

- AS 1301, *Communication with Audit Committees*
- AS 2701, *Supplementary Information*
- AS 2410, *Related Parties*

As a result, the AICPA reviewed the changes to determine where it would make sense to converge GAAS with PCAOB standards.

The new standard addresses an entity's significant unusual transactions, potential effects of uncorrected misstatements on future-period financial statements, and consultations with those outside the engagement team.

To clarify current GAAS, the new standard consistently uses the term *significant unusual transactions*, which are "significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual due to their timing, size or nature."

The new standard also enhances requirements to identify previously unidentified or undisclosed related parties or significant related party transactions and enhances the response to the risk of material misstatement associated with related parties.

The AICPA decided no amendments were necessary to converge with AS 2701, which deals primarily with broker-dealers.

Knowledge check

4. Which AS standard issued by the PCAOB was addressed in new SAS No. 135?
- a. AS 1301.
 - b. AS 2701.
 - c. AS 1005.
 - d. AS 2570.

SAS No. 137

SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, was issued in July 2019 and is effective for audits of financial statements for periods ending on or after December 15, 2020. Upon its effective date, it will supersede the extant AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*.

This project also stemmed out of the ASB's strategy to converge the SASs with the ISAs while tailoring to the U.S. environment. The standard provides guidance on the auditor's responsibilities when the auditor's report and audited financial statements are included in documents containing other information (OI). For purposes of the standard, OI is limited to annual reports, and a new definition of an annual report is provided.

Annual report. A document, or combination of documents, typically prepared on an annual basis by management or those charged with governance in accordance with law, regulation, or custom, the purpose of which is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements. An annual report contains, accompanies, or incorporates by reference the financial statements and the auditor's report thereon and usually includes information about the entity's developments, its future outlook and risks and uncertainties, a statement by the entity's governing body, and reports covering governance matters. Annual reports include annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public.

Even if a document is called an annual report, unless it meets the definition of an annual report, it is not in the scope of this proposed standard. OI is different from required supplementary information (see AU-C section 730, *Required Supplementary Information*) and supplementary information (see AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*).

Examples of items that do not qualify as annual reports include IRS Form 990, *Return of Organization Exempt From Income Tax* and IRS Form 5500, *Annual Return/Report of Employee Benefit Plan*. However, many nonprofits do issue annual reports for communications to the board and donors. In addition, the updated definition of annual reports of governments is intended to include comprehensive annual financial reports (CAFR) or other annual financial reports that include the government's financial statements and the auditor's report thereon.

When a client issues an annual report the auditor is required to consider whether a material inconsistency exists between the other information and the financial statements. They should also remain alert for indications that a material inconsistency exists between the other information and the auditor's knowledge obtained in the audit or a material misstatement of fact exists or the other information is otherwise misleading. If there is a material inconsistency or error, the auditor must respond appropriately. In addition, if the auditor receives the annual report prior to issuance of the

opinion on the financial statements (which is not required), then the auditor would report on the annual report as a separate section in the auditor's report to explain their responsibilities for the annual report.

The auditor's opinion on the financial statements does not cover the other information and the auditor is NOT required to obtain audit evidence beyond that required to form an opinion on the financial statements. Therefore, the primary audit procedures will include reading the annual report and remaining alert for contradictory or incorrect information.

SAS No. 138

SAS No. 138 was issued in December 2019 and addresses the definition of materiality. The original definition of materiality in the United States dates back to a US Supreme Court case. However, during the 2000s both FASB and AICPA decided to converge the definition with international standards. In 2018, FASB after ending its convergence effort reverted back to the original definition of materiality. As such, the AICPA, while still maintaining an active convergence effort, also agreed to update the definition to be more consistent with US standard setters. The largest change is in the concept of could (a hypothetical) to would (a more definitive scenario). The updated definition also incorporates the concept of substantial likelihood and the framework of a reasonable user. SAS No. 138 updates the language in the auditor's report. Conforming amendments are also made to AU-C 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards, AU-C 320, Materiality in Planning and Performing an Audit, AU-C 450, Evaluation of Misstatements Identified During the Audit, and AU-C 600, Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors).

Knowledge check

5. A key change in the definition of materiality is the word?
- a. is
 - b. could
 - c. will
 - d. for

Statements on Standards for Attestation Engagements

SSAE 19

SSAE 19, *Agreed-Upon Procedures Engagements*, was issued in December 2019. It supersedes SSAE 18, *Attestation Standards: Clarification and Recodification, AT-C section 215, Agreed-Upon Procedures Engagements* and amends SSAE No. 18 AT-C section 105, *Concepts Common to All Attestation Engagements*. The standard addresses many practice issues that have made it difficult for practitioners to comply with the AUP standards. The first thing the standard does is update AT-C 105 to remove the requirement to obtain an assertion in AUPs as sometimes the responsible party may not have the ability or willingness to perform its own measurement or evaluation of the subject matter. Another practice issue addressed is now the CPA, the responsible party, or the engaging party can write the procedures. The prior standard did not permit the CPA to write the procedures for the client. Prior to the issuance of the report, the engaging party is required to agree to and acknowledge that the procedures performed are appropriate to meet the intended purpose of the engagement. As a result, the intended uses are no longer required to take responsibility for the sufficiency of the procedures which was oftentimes difficult to obtain. In addition, AUP reports no longer require restriction and can be issued as general purpose. The report is also updated to incorporate the statement of independence in SAS No. 134. The standard is effective for AUP reports dated on or after July 15, 2021 and early implementation is permitted.

Knowledge check

6. SSAE 19 updates the requirements for which type of attestation engagement?
- examination
 - review
 - agreed upon procedure
 - compilation

SSAE 20

SSAE 20, Amendments to the Description of the Concept of Materiality, was issued in December 2019. Similar to SAS No. 138, this standard updates the definition of materiality to be consistent with US Standard Setters. It will be effective for practitioners' examination reports dated on or after December 15, 2020 and practitioners' review reports dated on or after December 15, 2020.

Recently issued changes to the Code of Professional Conduct

Leases

Due to the changes in the definition of a lease and the change in accounting for leases by both GASB and FASB, the AICPA started a project to update the “Leases” interpretation (ET sec. 1.260.040) in the Code of Professional Conduct. The prior standard included exceptions for certain types of leases. Under the new standard, when a CPA enters into or has a lease with an attest client, self-interest, familiarity, and undue influence threats may exist.

If a covered member who is an individual on the attest engagement team, an individual in a position to influence the attest engagement, or the firm enters into a lease or renegotiates terms of an existing lease with an attest client during the period of the professional engagement, threats to compliance with the “Independence Rule” would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards.

Independence would be impaired, unless all of the following safeguards are met at the time of entering into or renegotiating the lease:

- a. The lease is on market terms and established at arm’s length.
- b. The lease is not material to any of the parties to the lease. When evaluating materiality, all leases between the covered member and the attest client should be considered in the aggregate.

The covered member must pay the lease amounts in accordance with the lease terms and provisions by the due date to prevent threats to independence.

For existing leases, the covered member should evaluate the significance of any threats to determine whether the threats are at an acceptable level. If the covered member determines that threats are not at an acceptable level, the covered member should apply safeguards to eliminate or reduce the threats to an acceptable level. If no safeguards are available to eliminate or reduce threats to an acceptable level, independence would be impaired.

The “Client Affiliates” interpretation (ET sec. 1.224.010) is now revised to apply for leases held with certain affiliates of a financial statement attest client.

These changes are effective for fiscal years beginning after December 15, 2019.

Information System Services (1.295.145)

In June 2019, the section of the Code of Professional Content formerly known as “Information Systems Design, Implementation, or Integration” was updated. Terminology was refreshed and the standard was made more precise regarding what factors impair independence when a member in public practice assists a client with their information system services. The interpretation applies to all attest

engagements, including examinations, agreed upon procedures, and others in which the subject matter of the engagement is not financial statements.

The standard defines a financial information system (FIS) as:

“a system that aggregates source data underlying the financial statements or generates information that is significant to either the financial statements or financial processes as a whole.”

Additional definitions for this standard are as follows:

- “Designing an information system means determining how a system or transaction will function, process data, and produce results (for example, reports, journal vouchers, and documents such as sales and purchase orders) to provide a blueprint or schematic for the development of software code (programs) and data structures.”
- “Developing an information system entails creating software code, for individual or multiple modules, and testing such code to confirm it is functioning as designed.”

When the project is not related to a financial information system, threats are considered to be at an acceptable level if the CPA performed design, development or implementation services only when the normal nonattest service requirements are met (i.e., client takes responsibility etc.).

The following chart summarizes the rules when a member is performing work on a FIS:

Design	Impairs independence
Develop	Impairs independence
Installing	Follow nonattest service rules
Configure	Follow nonattest service rules
Customize	Impairs independence
Interface	Impairs independence (exception for application programming interfaces)
Translate Data	Impairs independence (exception for application programming interfaces)
Ongoing System and Network Maintenance, Support & Monitoring	Impairs independence
Separate & Distinct System and Network Maintenance, Support & Monitoring	Follow nonattest service rules

This interpretation is effective beginning Jan. 1, 2021. Early implementation is allowed.

Knowledge check

7. Which is a prohibited service?
- Use of APIs to translate data
 - Distinct network support
 - Developing a FIS
 - Installing a FIS

State and Local Government Client Affiliates (1.224.020)

Effective for years beginning after December 15, 2020, the new State and Local Government Client Affiliates interpretation was issued in June 2019. While the definition of client affiliate has been used for several years under the Code, PEEC recognizes that governmental entities are different in that the financial reporting entity rolls up at various levels. Therefore, PEEC created a new definition of an affiliate that is unique to governmental entities that follow GASB.

“An affiliate of a financial statement attest client exists in all the following situations:

- The entity is included in the financial statement attest client’s financial statements and the member or member’s firm does not make reference to another auditor’s report on the entity.
- The entity is included in the financial statement attest client’s financial statements, the member or member’s firm makes reference to another auditor’s report on the entity, and
 - the entity is material to the financial statement attest client’s financial statements as a whole and
 - the financial statement attest client has more than minimal influence over the entity’s accounting or financial reporting process. There is a rebuttable presumption that the financial statement attest client has more than minimal influence over the accounting or financial reporting process of funds and blended component units.
- The entity is a material excluded entity, and the financial statement attest client has more than minimal influence over the entity’s accounting or financial reporting process. A material excluded entity is an entity that is required under the applicable financial reporting framework to be included in the financial statements of the financial statement attest client but is, nevertheless, excluded by the financial statement attest client and is material to the financial statement attest client’s financial statements as a whole. There is a rebuttable presumption that the financial statement attest client has more than minimal influence over the accounting or financial reporting process of funds and blended component units.
- The investor, which is either the financial statement attest client or an affiliate as defined in item (i) of this definition, has an investment in an investee when the investor either
 - controls the investee, unless the investment in the investee is trivial and clearly inconsequential to the financial statement attest client’s financial statements as a whole, or
 - has significant influence over the investee and the investment in the investee is material to the financial statement attest client’s financial statements as a whole.”

Threats to independence may arise as a result of financial interests or other relationships with governmental affiliates of a financial statement attest client. The interpretation highlights that other relationships can cause threats to independence, including:

- a. A covered member's immediate family member is in a key position with a nonaffiliate that includes the financial statement attest client in its financial statements and the nonaffiliate provides accounting staff, shares financial information systems, or establishes internal controls over financial reporting for the financial statement attest client.
- b. The member or member's firm is considering providing financial information system design services to a nonaffiliate in which the same financial information system would also be used by the financial statement attest client.
- c. A covered member has a financial interest in a nonaffiliate that includes the financial statement attest client in its financial statements, and the nonaffiliate prepares the financial statements for the financial statement attest client.
- d. The financial statement attest client participates in a public-private partnership or joint venture that does not meet the definition of an investment in paragraph .03c of this interpretation. A covered member has a financial interest in an organization that is also involved with the public-private partnership or joint venture.
- e. A covered member owns utility bonds issued by a nonaffiliate, and the financial statement attest client is responsible for payment of the utility bond debt service.
- f. A covered member owns conduit debt issued by the financial statement attest client on behalf of a nonaffiliate. The conduit debt is not accounted for on the financial statements of the financial statement attest client, and the debt service is paid by the nonaffiliate."

Therefore, going forward, it is important that auditors of governmental entities take the time to properly identify client affiliates and consider any threats to independence – which may be more time intensive due to the way governmental entities prepare financial statements.

PEEC has also issued a three-year plan document on potential future projects which can be found: <https://www.aicpa.org/content/dam/aicpa/interestareas/professionalethics/community/downloadabledocuments/peecstrategy-workplan-consultation.pdf>

Other projects to monitor

Check the AICPA website at www.aicpa.org to follow the status of the following projects:

- Management's Specialist
- Risk Assessment

ASB exposure drafts are posted to the AICPA's website at <https://www.aicpa.org/research/exposedrafts/accountingandauditing.html>

In 2019, the ASB issued a consultation paper on its strategy and workplan. Information regarding potential projects can be found at:

<https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/asb/downloadabledocuments/asb-strategy-consultation-paper.pdf>

2018 mid-year progress report – Enhancing Audit Quality

Background

The AICPA launched its Enhancing Audit Quality (EAQ) Initiative in May 2014 and released a related EAQ discussion paper on August 7, 2014. The EAQ Initiative is a holistic effort to consider auditing of private entities through multiple touch points, especially where quality issues have emerged. The goal is to align the objectives of all audit-related AICPA efforts to improve audit performance.

The EAQ Initiative is a six-point plan to improve audit quality and therefore preserve the prominent and respected role the CPA in public practice plays in the business community. The objective of this program is to improve consistency of quality by focusing the attention of firms and peer reviewers on the following:

- New industries
- Industries with new/rising risks
- Employee benefit plans
- Municipalities
- Audit areas of increased risk
- Documentation of sufficient appropriate audit evidence
- Nonattest services to audit clients
- Areas with increased inspection areas in the past

As part of the Enhancing Audit Quality Initiative, the AICPA issued a document titled “Enhancing Audit Quality: 2017 Highlights and Progress.” The document provides insights into the reviews of Single Audits that received enhanced oversight. For all audits (including single audits), 55% of all audits reviewed were materially nonconforming in 2016.

The most common causes of non-conformity were

- inadequate or nonexistent audit documentation,
- no testing of internal controls over compliance in single audits, and
- no testing of one or more applicable compliance requirements in single audits.

The rate of non-conformity with professional standards peer reviewers detected on must-select engagements has more than tripled since 2015. Three percent of firms in the FAC database were not properly enrolled in the peer review program or failed to report to their peer reviewer that they performed a single audit (evaluation performed in 2015–16 for year-ends in 2013).

Twenty-three percent of all single audits subject to enhanced oversight were materially non-conforming with professional standards due to failure to properly test controls over compliance. Sixteen percent of single audits subject to enhanced oversight were materially non-conforming due to failure to properly test direct and material compliance requirements.

The AICPA identified the following three key factors driving single audit quality:

- The more single audits a firm performed every year (regardless of firm size), the more likely a given single audit was to conform to professional standards.
- GAQC membership firm members had two times greater conformity than non-members.
- The number of single audits the engagement partner performed annually

GAQC members who performed 11 or more single audits annually were found to be in conformity 100% of the time. The theme is practice makes perfect, and commitment to quality is key to audit quality success.

Knowledge check

8. For all audits subject to enhanced oversight in 2016, what percent were materially nonconforming?
- a. 25%.
 - b. 35%.
 - c. 45%.
 - d. 55%.

The 2018 EAQ areas of focus were risk assessment, documentation, single audits, auditing in the future, and peer review. In 2018, the AICPA issued a document titled “Enhancing Audit Quality: 2018 mid-year progress report.” The document provides updates on five areas, three of which were 2018 areas of focus, as part of the EAQ Initiative.

- Peer review
 - Eighty-six percent of firms improved in their next peer review when the Peer Review Program required a third-party review of their engagements or quality control documents. A 2015 study found that 16% of firms required to subject their employee benefit plan audits to peer review had failed to do so. A 2017 study found that noncompliance had been cut in half.
- Single audits
 - More than 8,600 auditors and organizations subject to single audits learned about single audit resources and the results of a November 2017 study conducted by the AICPA on the factors driving single audit quality.
- Employee benefit plan audits
 - The AICPA presented a webcast in December 2017 titled, “EBP Audits: Common Misconceptions and How to Address Them.”
- Quality control
 - There were more than 7,900 quality control resource downloads in 2017, based on more than 4,900 visits to the Private Companies Practice Section’s Invigorate the Focus on Quality Toolkit.
- Documentation
 - The progress report noted that more than 50% of all material noncompliance with auditing standards is due to inadequate audit documentation. A quiz to test knowledge of the audit documentation standard was published in *Journal of Accountancy* in 2017 (see the quiz at journalofaccountancy.com/documentation). More than 10,000 people took the quiz. There were more than 15,000 visits to the free audit documentation toolkit at aicpa.org/documentation.

Addressing common audit deficiencies

Lack of documentation

Lack of sufficient documentation in audits has consistently been the number one audit quality issue. One in every 4 engagements (or 25%) subject to enhanced oversight by the Peer Review Program is materially non-conforming because of poor documentation.

Per an article in the *Journal of Accounting* June 2017 issue, interviews with firms subject to enhanced oversight uncovered three common misconceptions that drive nonconformity.

1. Auditors can meet their overall audit objectives without documenting their work.
2. A sign-off on an audit program is sufficient documentation of a detail test.
3. Oral explanation can substitute for written documentation to meet the requirements of AU-C section 230, *Audit Documentation*.

Some of the more common examples where there is frequently lack of documentation include tests of controls over compliance in single audits, direct and material compliance requirement determinations in single audits, eligibility testing in EBP audits, and consideration of systems and organization controls reports.

What is documentation?

Per AU-C section 230, audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The terms *working papers* or *workpapers* are often used synonymously.

Audit documentation must provide evidence of the auditor's basis for a conclusion regarding the overall objective of the audit and evidence that the audit was planned and performed in accordance with GAAS and applicable legal and regulatory requirements.

The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, with no previous connection with the audit, to understand the nature, timing, and extent of the audit procedures performed, the results of those audit procedures and the supporting audit evidence obtained, as well as the audit conclusions reached (including significant findings and issues, and primary professional judgments made in reaching those conclusions).

Audit documentation may be recorded on paper or on electronic media. Preliminary drafts, initial thinking, and incomplete notes do not need to be maintained if they are superseded by a final draft. Additionally, oral explanation may be used to explain or clarify audit documentation, but no amount of oral explanation can substitute for missing or incomplete written documentation.

Why does documentation matter?

AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, paragraph .19 states that obtaining reasonable assurance requires the auditor to “obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion.” Obtaining audit evidence requires that work be completed and appropriately documented.

AU-C section 230 further states that the objective of the auditor is to prepare documentation that provides a sufficient and appropriate record of the basis for the auditor’s report and evidence that the audit was planned and performed in accordance with GAAS and applicable legal and regulatory requirements.

Audit documentation serves several additional purposes such as the following:

- Assisting the engagement team to plan and perform the audit
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work and to discharge their review responsibilities in accordance with AU-C section 220
- Enabling the engagement team to demonstrate that it is accountable for its work by documenting the procedures performed, the audit evidence examined, and the conclusions reached
- Retaining a record of matters of continuing significance to future audits of the same entity
- Enabling the conduct of quality control reviews and inspections in accordance with QC section 10, *A Firm’s System of Quality Control (AICPA Professional Standards)*
- Enabling the conduct of external inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements
- Assisting an auditor who reviews a predecessor auditor’s audit documentation
- Assisting auditors to understand the work performed in the prior year as an aid in planning and performing the current engagement

Even in the case of small audits where all work is completed by a sole audit partner, audit documentation must still be prepared in a manner that can be understood by an experienced auditor with no previous knowledge of the engagement for peer review or litigation purposes.

Form, content, and extent of audit documentation

Documentation should be prepared on a timely basis because it helps enhance audit quality, facilitates effective review before an auditor’s report is finalized, and increases the likelihood that documentation will be accurate. Additionally, final assembly of the audit documentation in an audit file should be completed no later than 60 days following the report release date.

As previously noted, audit documentation should be sufficient to enable an experienced auditor, with no previous connection with the audit, to understand the nature, timing, and extent of the audit procedures performed, the results of those audit procedures and the supporting audit evidence obtained, as well as, the audit conclusions reached (including significant findings and issues and primary professional judgments made in reaching those conclusions).

However, the form, content, and extent of audit documentation will depend on several factors including the following:

- Size and complexity of the entity
- Nature of the audit procedures to be performed
- Identified risks of material misstatement
- Significance of the audit evidence obtained
- Nature and extent of exceptions identified
- Need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained
- Audit methodology and tools used
- Extent of judgment involved in performing the work and evaluating the results

For each audit procedure performed, the auditor should document the following:

- The identifying characteristics of the specific items or matters tested
- Who performed the audit work and the date work was completed
- Who reviewed the audit work along with the date and extent of such review

Best practices for audit documentation

The November 2017 issue of the *Journal of Accountancy* highlights the following four best practices for effective audit documentation.

1. Take a smart approach to planning by mapping the audit in a memo to lay out the biggest risks, strategies to mitigate each risk, and references to where and how work is to be performed. Reference the audit plan frequently and revise the memo as the audit progresses and new risks are identified.
2. Embrace standardization across your organization and let go of immaterial personal preferences that may lead to inconsistencies and inefficiencies. Additionally, document with intent and do not allow unnecessary client documentation to clutter the client file.
3. Document while performing audit procedures, instead of waiting to catch up on documentation later. This approach will ultimately save time and ensure high quality documentation. Additionally, issuing the audit report timely helps limit the auditor's responsibility for subsequent events procedures.
4. Document with the future in mind. Ensure that this year's documentation will provide next year's audit team with a solid foundation. This will help eliminate future rework and inefficiencies.

Knowledge check

9. Final assembly of the audit documentation in an audit file should be completed no later than when?
 - a. 45 days following the audit report date.
 - b. 60 days following the audit report date.
 - c. 45 days following the report release date.
 - d. 60 days following the report release date.

Improper risk assessment

The goal of identifying, assessing, and responding to risks of material misstatement is at the heart of every audit and drives every audit procedure, and yet, an AICPA Peer Review Program study found that more than 1 in 10 firms are not properly assessing risk or linking their assessments to their audit procedures. In fact, more than 10 years after the SAS Nos. 104–111 provided a new road map for executing the audit, many auditors still believe they can perform a quality audit without properly assessing their client's risks. In reality, without assess their clients' risks, an auditor will have no basis for designing a quality audit plan that addresses those risks. As a result, auditors will have no way of knowing whether their procedures and substantive testing actually reduce audit risk to an appropriately low level.

Non-conformity related to misconceived notions about the importance of risk assessment is particularly prevalent in small- to medium-sized entities and is leading to violations of professional standards.

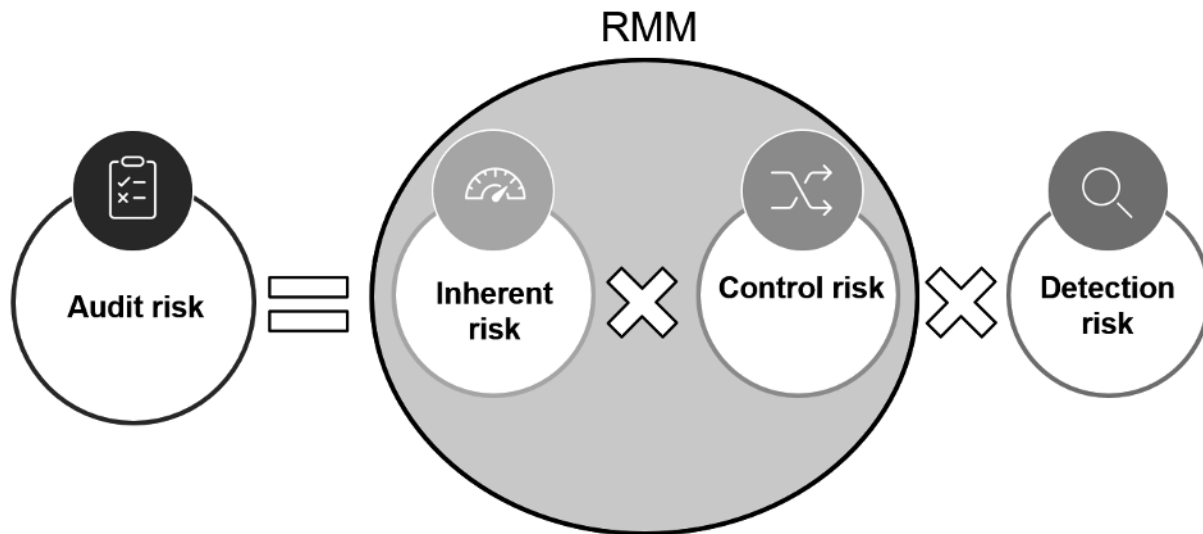
The most common areas of noncompliance found in the AICPA Peer Review Program study were:

- 40% of identified issues related to failure to gain an understanding of internal control when identifying the client's risks.
- 14% of issues related to incomplete or nonexistent risk assessment.
- 24% of issues related to auditors not linking their risk assessment to their response
- 13% of issues related to auditors assessing control risk as less than high without appropriate tests of controls.

The risk assessment process is important for every audit, regardless of the size or industry in which the client operates. An effective risk assessment requires an auditor to first obtain an understanding of the client and its environment. This includes gaining knowledge of internal control relevant to the audit, evaluating the design of those controls, and assessing whether the controls have been implemented. Once this understanding of the client is established, audit procedures can be designed that are clearly linked and responsive to the risks identified. This is sometimes referred to as a "top-down" approach because it starts with a broader understanding of the client, not at the procedure level. Although the AICPA does not require an auditor to test the operating effectiveness of an internal control, procedures around design and implementation must be performed.

Audit risk model

Audit risk is the risk that the firm will issue the wrong audit opinion when the financial statements are materially misstated. This includes inherent risk (the risk of material misstatement assuming there are no related controls); control risk (the risk that the client's controls will not prevent or detect a material misstatement); and detection risk (the risk that the auditor will not detect a material misstatement). Inherent and control risk combine to form risk of material misstatement, or RMM.



The risk of material misstatement is the risk that the financial statements are materially misstated prior to the audit. This consists of two components, inherent risk and control risk, which are defined in AU-C section 200.

- Inherent risk: 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: 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 internal control.

In order to express an opinion with a reasonable level of assurance, an auditor must reduce audit risk to an acceptably low level. The only way for the auditor to control audit risk is to drive detection risk (the risk that audit procedures will not detect misstatement) to a low level. As implied in the audit risk model, the higher the risks of material misstatement, the more work needs to be done to reduce detection risk.

Paragraph .03 of AU-C section 315 says that risk assessment provides "a basis for designing and implementing responses to the assessed risks of material misstatement." In other words, to perform an audit in accordance with professional standards, the auditor should

- first, gain an understanding of the client and its internal controls to identify the client's risks of material misstatement, then
- assess the identified risks; and
- finally, design procedures that respond to those risks.

If auditors do not assess their clients' risks, they will have no basis for designing audit plans with procedures that respond to those risks. Regardless of the amount and type of substantive testing they perform, the auditors will have no way of knowing whether their procedures reduced audit risk to an appropriately low level. As such, a failure to comply with AU-C section 315 represents a failure to obtain sufficient appropriate audit evidence to support the opinion.

Significant risks are defined in AU-C section 315 as “an identified and assessed risk of material misstatement that, in the auditor’s professional judgment, requires special audit consideration.”

Significant risks often relate to significant nonroutine transactions and matters that require significant judgment. Routine noncomplex transactions that are subject to systematic processing are less likely to give rise to significant risks.

In exercising professional judgment about which risks are significant risks, an auditor should consider the following:

- Whether the risk is a risk of fraud
- Whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention
- The complexity of transactions
- Whether the risk involves significant transactions with related parties
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty
- Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual
 - Such non-routine transactions are often less likely to be subject to routine controls. However, management may have other responses intended to deal with such risks.

Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements as used by the auditor to consider the different types of potential misstatements that may occur. A **relevant assertion is then a** financial statement assertion that has a **reasonable possibility** of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of internal controls.

Examples of assertions include: occurrence, existence, completeness, cutoff, classification, accuracy, valuation and allocation, understandability, and rights and obligations.

Audit procedures are designed to respond to assertion-level risks, so the risks should be assessed at the following:

- The relevant assertion-level. This means an auditor should assess risk for assertions that have a reasonable possibility of material misstatement. It does not, however, mean every assertion for every account.
- The financial statement-level. This means an auditor should assess risks which are pervasive to the financials and which would affect numerous assertions, such as high turnover of key roles in the accounting department. Ultimately, an auditor will aim to identify the specific assertions that financial statement level risks will impact.

Common audit deficiencies found by the AICPA include assessing risk at the account level in lieu of the assertion level.

As a reminder, performing risk assessment procedures such as identifying and assessing risk, do not reduce control risk. The only way to reduce control risk is to test the operating effectiveness of the

controls. The AICPA does not require the testing of controls except when the auditor plans to rely on the controls and reduce control risk.

Linkage is key

It was found that many auditors, particularly those serving smaller clients, appear to be documenting risk assessments in accordance with AU-C section 315. However, they would then proceed to perform the audit with little regard to the results of that assessment (such as using a standard set of procedures or following the same pattern as last year's audit). By failing to link their audit procedures to the completed risk assessment they are not taking credit for the work they've done by focusing their procedures on addressing the client's risks. Instead they are often performing significant substantive procedures on every audit area regardless of risk. This leads to inefficiency and over-auditing in some areas and can lead to noncompliance in other areas if the auditor did not address the risks properly.

What if the client has no controls?

A common misconception is the belief that a client can have no controls. Conversely, even the smallest of reporting entities has some controls, although they may be weak or high-level. Because a control is any policy or procedure used by a reporting entity to prevent, or detect and correct, a misstatement, claiming that a reporting entity has no controls would suggest that an entity has no ability to prevent, or detect and correct, any type of misstatement. Such a suggestion would call into question the auditor's ability to express an opinion with a reasonable level of assurance regardless of how many procedures they perform.

Even the smallest of reporting entities have some controls, like the following:

- Monitoring by business owners or management
- Computer login credentials
- Communications from management to employees about the importance of doing things right

More common than a complete lack of controls is incomplete documentation of controls. At smaller nonpublic entities, there may be certain controls that have been put in place but have not been formally documented. Even without proper client documentation, an auditor may test a control as part of an audit. In this case, it may also be appropriate to issue a management recommendation that the client have a formal documentation process for any controls they have established and placed in operation.

As a reminder, the five components of internal control are the following:

- Control environment
- Entity's risk assessment process
- Information system, including the related business processes relevant to financial reporting, and communication
- Control activities employed by the organization
- Monitoring of controls

Improper use of third-party practice aids

Standardized, third-party practice aids can be valuable tools that provide auditors with useful insights when planning and conducting an audit. However, such tools are not intended to be used in place of a risk assessment. Even if auditors use standardized practice aids, they are still required to perform a risk assessment and show the linkage between that assessment and their procedures. Auditors are never to assume that recommended procedures in standardized practice aids will address a particular client's specific risks. Tailoring audit programs from third party practice aids ensures that risks have been properly addressed.

Even clients of similar size in the same industry will not have the exact same risks and thus will not require the exact same audit responses. As noted earlier, a strong understanding of a client and its environment, policies, and controls is necessary to design procedures that specifically address their unique significant risks.

Tips for addressing risk in audit engagements:

- Obtain a strong understanding of the client and its environment, including the system of internal control.
- Identify the client's risks, including any significant risks.
- Document the linkage between the risk assessment and the procedures on the audit programs.
- Design and perform procedures that specifically address any significant risks.
- Revisit the risk assessment and audit plan throughout the engagement.
- Utilize free tools available at <https://www.aicpa.org/content/aicpa/eaq/aicpa-risk-assessment-resources.html> to document the risk assessment, train staff, or help perform an effective internal inspection.

When documenting the audit, an auditor should include the following:

- Overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures performed
- Linkage of those procedures with the assessed risks at the relevant assertion level
- Results of the audit procedures, including the conclusions when such conclusions are not otherwise clear

The AICPA does not have required terminology for assessing risk. Some practice aids use a numbering system, others use high, moderate and low. The standards makes no reference to proper terminology. As always, the form and extent of audit documentation is a matter of professional judgment. It is influenced by the nature, size, and complexity of the entity, the internal control environment, availability of information from the entity, and the audit methodology and technology used by the auditor.

Impact on peer review

The Peer Review Board approved a new section to the AICPA Peer Review Program Manual, PRP section 3100, *Evaluation of Noncompliance with the Risk Assessment Standards*, effective for reviews commencing on or after October 1, 2018 through reviews commencing on or before September 30, 2021.⁴

⁴ The AICPA Peer Review Manual can be found at <https://www.aicpa.org/interestareas/peerreview/resources/peerreviewprogrammanual.html>, and PRP section 3100 may be found at <https://www.aicpa.org/content/dam/aicpa/research/standards/peerreview/downloadabledocuments/guidance.pdf>.

If a peer reviewer finds noncompliance with the risk assessment standards, the engagement should be deemed non-conforming.

If the noncompliance is not considered isolated, they should issue the following:

- A finding if no deficiencies or significant deficiencies related to other engagement performance issues are noted, even if all the engagements reviewed are nonconforming solely due to noncompliance with the risk assessment standards.
- A deficiency or significant deficiency if deficiencies and significant deficiencies related to other omitted audit procedures exist.
- A finding if there are deficiencies or significant deficiencies related to elements of a firm’s system of quality control that did not result in omitted audit procedures (for example, monitoring or tone at the top).

Non-compliance noted	Isolated or Systemic	Conclusion
Failure to comply with the Risk Assessment Standards	Isolated	MFC
Failure to comply with the Risk Assessment Standards	Systemic	FFC and Implementation Plan
Failure to comply with the Risk Assessment Standards and other deficiencies or significant deficiencies exist	Systemic	Deficiency or Significant Deficiency with Corrective Action

Changes are currently being made to Peer Review Integrated Management Application (PRIMA) to allow peer reviewers to indicate the number of non-conforming engagements due to noncompliance with the risk assessment standards. This will provide a mechanism for the AICPA to track the effectiveness of the initiative. These changes are expected to be implemented in early 2019.

Other resources available to auditors and peer reviewers include the Internal Inspection Practice Aid *Addressing Noncompliance with AU-C 315 and 330* at <https://www.aicpa.org/content/dam/aicpa/interestareas/peerreview/eaq/eaq-risk-internal-inspection-aid.pdf>.



Appendix 1A

DOCUMENTATION CASE STUDY

For each example in part 1 and part 2, indicate whether the documentation standard has been met. If not, what attributes of adequate documentation are missing?

Part 1

Client has one note receivable, and the note balance is material to the financial statements.

Auditor tested the note for existence, rights, and valuation.

No significant findings or issues were noted.

No significant judgments were made.

Example 1

Audit program step	Preparer signoff and date	Reviewer signoff and date
Obtain and review note(s) receivable. Test existence, rights and valuation assertions.	CRM 3/30/X7	BAM 4/2/X7

1. Has the auditor documented the nature and extent of the procedures, including the identifying characteristics of the items tested?
2. Has the auditor documented the timing of the procedures?
3. Has the auditor documented the results of the procedures?

Example 2

Audit program step	Preparer signoff and date	Reviewer signoff and date
Obtain and review note(s) receivable. Test existence, rights and valuation assertions.	CRM 3/30/X7	BAM 4/2/X7
<p>CRM Note: Controller provided audit team with note issued 11/17/20X6. Reviewed note, verifying existence and that the entity is the holder of the note. Received letter from the borrower (see working paper B200) confirming the face amount of \$112,000 was outstanding at fiscal year-end and matures on 5/31/X7. Tied face amount back to TB.</p>		

1. Has the auditor documented the nature and extent of the procedures, including the identifying characteristics of the items tested?
2. Has the auditor documented the timing of the procedures?
3. Has the auditor documented the results of the procedures?

Part 2

Client has numerous notes receivable, and the total balance is material to the financial statements.

Auditor has concluded (and documented, as part of planning) that notes with balances over \$70,000 will be subject to testing. Auditor tested certain notes for existence, rights, and valuation.

No significant findings or issues were noted.

No significant judgments were made.

Example 3

Audit program step	Preparer signoff and date	Reviewer signoff and date
Obtain and review note(s) receivable. Test existence, rights and valuation assertions.	CRM 3/30/X7	BAM 4/2/X7
CRM Note: Selected a sample of notes for testing. Notes were provided by controller. Reviewed notes, testing for existence, rights and valuation. No exceptions noted.		

1. Has the auditor documented the nature and extent of the procedures, including the identifying characteristics of the items tested?
2. Has the auditor documented the timing of the procedures?
3. Has the auditor documented the results of the procedures?

Example 4

Client Name	Example Company 2	Working Paper #	EX-2
Working Paper Title	Short-Term Notes Receivable	Preparer	CRM
Balance Sheet Date	12/31/20x6	Date Completed	3/30/X7
Prepared By Client?	No	Reviewer	BAM
		Date Reviewed	4/2/X7

Objective: To verify that the notes receivable appearing on the balance sheet exist, Example Company 2 has rights to them, and their valuation is appropriate.

Customer's Name	Issue Date	Maturity Date	Face Amount	
Customer A	11/17/20x6	5/19/20x7	112,000.00	T, C, (A)
Customer B	9/15/20x6	6/30/20x7	330,000.00	T, C, (A)
Customer C	9/1/20x6	4/5/20x7	72,000.00	T, C, (A)
Customer D	7/24/20x6	6/18/20x7	91,000.00	T, C, (A)
			605,000.00	

Tickmark Legend

T Traced face amount, issue and maturity dates to note

C Agreed to confirmation

(A) Agreed to client's list of notes receivable at working paper EX-2a, which ties to Trial Balance

1. Has the auditor documented the nature and extent of the procedures, including the identifying characteristics of the items tested?
2. Has the auditor documented the timing of the procedures?
3. Has the auditor documented the results of the procedures?



Appendix 1B

EXAMPLE AUDITOR'S REPORT AND CASE STUDY

Independent Auditor's Report

[Appropriate Addressee]

Report on the Audit of the Financial Statements¹

Opinion

We have audited the financial statements of XYZ Not-for-Profit Organization, which comprise the statement of financial position as of September 30, 20X1, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of September 30, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of XYZ Not-for-Profit Organization and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Key Audit Matters

[This section of the auditor's report is included only if the auditor is engaged to communicate key audit matters.]

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with section 701, Communicating Key Audit Matters in the Independent Auditor's Report]

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

¹ The subtitle "Report on the Audit of the Financial Statements" is unnecessary in circumstances in which the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern for *[insert the time period set by the applicable financial reporting framework, which for FASB-reporting entities is one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable)]*.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the XYZ Not-for-Profit Organization's internal control. Accordingly, no such opinion is expressed.²
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Not-for-Profit Organization's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control related matters that we identified during the audit.

Other Information [or another title, if appropriate, such as "Information Other Than the Financial Statements and Auditor's Report Thereon"]

² In circumstances in which the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of XYZ Not-for-Profit Organization's internal control. Accordingly, no such opinion is expressed."

[Reporting in accordance with the reporting requirements in AU-C section 720, The Auditor's Responsibilities Relating to Other Information Included in Annual Reports (refer to illustrations in the exhibit of AU-C section 720)]³

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.]

[Signature of the auditor's firm]

[City and state where the auditor's report is issued]

[Date of the auditor's report]

Case Study Part 1

Draw a line to the corresponding section header for each statement below:

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Management's responsibility

Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the financial statements of the current period.

Key Audit Matters

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of NFP Entity as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

³ Paragraph .24 of SAS No. 137, The Auditor's Responsibilities Relating to Other Information Included in Annual Reports, describes the separate section of the auditor's report that is required if other information, whether financial or nonfinancial, is included in an entity's annual report, as defined. SAS No. 137 is effective for audits of financial statements for periods ending on or after December 15, 2020. Early implementation is not permitted. This appendix has not been updated for SAS No. 137. Readers are also encouraged to consult the full text of the SAS at <https://www.aicpa.org/interestareas/frc/auditattest/auditing-standards-information-and-resources.html>.

Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists.

Auditor's Responsibility

We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits.

Opinion

We have audited the financial statements of NFP Entity, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.

Basis for Opinion

The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS).

Case Study Part 2

Based on the updated report in SAS 134, fill in the blank with the word(s) that properly completes the sentence:

Exercise professional _____ and maintain professional skepticism throughout the audit.

Identify and _____ the risks of material misstatement of the financial statements, whether due to fraud or _____, and design and perform audit procedures responsive to those risks.

Obtain an _____ of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the ABC Company's internal control.

Evaluate the _____ of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall _____ of the financial statements.

Conclude whether, in our judgment, there are conditions or events, considered in the _____, that raise substantial doubt about ABC Company's ability to continue as a going concern for a _____ period of time.

In our opinion, the accompanying financial statements present fairly, in all _____ respects, the financial position of NFP Entity as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most _____ in our audit of the financial statements of the current period.

Management is responsible for the _____ and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and _____ of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to _____ or _____.

In preparing the financial statements, _____ is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern for [insert the time period set by the applicable financial reporting framework].

Our _____ are to obtain _____ assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our _____.

_____ assurance is a _____ level of assurance but is not _____ assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will _____ detect a material misstatement when it exists.

The risk of not detecting a material misstatement resulting from _____ is higher than for one resulting from _____, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.



Appendix 1C

NOT-FOR-PROFIT ACCOUNTING AND AUDIT COMPETENCY RESOURCE

Not-for-profit member section

In May 2015, the AICPA launched a new membership section for CPAs in public practice as well as those who work with or for a not-for-profit. The AICPA's Not-for-Profit Section (NFP section) provides support and resources in the areas of audit, financial accounting, and tax for members and other finance professionals. Those who have management or governance responsibilities, including those who serve as board members or as volunteers, are eligible to join the AICPA as a non-CPA associate. AICPA members, including, associates and non-CPA associates are eligible to join the NFP Section.

Benefits for NFP section members include the following:

- Timely communications covering breaking news. E-alerts and interactive webcasts will inform members when standard setters and regulatory agencies issue new guidance.
- Tools and resources. There is a wide-range of information including articles and tools that provide a deeper dive into topics such as risk management, communicating with audit committees, allocation of functional expenses, and Form 990 red flags.
- Sample financial statements and note disclosures.
- Board governance and accounting policy examples.
- Tools including a Form 990 worksheet, internal control checklists, example management letter comments, and reference charts.
- CPE-eligible courses.

NFP certificate programs

The AICPA offers two certificate programs for not-for-profit professionals. These programs are available to anyone with an interest in learning more about financial management of NFPs.

Not-For-Profit Certificate I

The Not-for-Profit (NFP) Certificate I program is specially designed to help accountants and others build the knowledge needed to gain a basic understanding of these entities by providing a foundation in not-for-profit accounting, tax compliance, governance and assurance. The program provides 24 courses on demand, which total 40 hours of CPE delivered in three topical tracks.

Participants learn about GAAP reporting standards that apply to NFPs, including financial statement presentation and disclosure requirements, state and federal filing requirements for tax-exempt organizations, best practices in board governance, financial oversight, internal controls, fraud, and other risks, and audit planning considerations.

Not-for-Profit Certificate II

A more advanced version, Not-For-Profit Certificate II, provides 30 hours of CPE through 17 courses that build on the core principles presented in the first program. There is no requirement to complete Certificate I to take Certificate II. The program is offered online using video presented by leading NFP

industry experts. Topics include how to prepare financial statements, how to complete IRS Form 990, how to build complex budgets, how to perform risk assessments, how to guide the strategic planning process, and how to work with an NFP's governing board. Learning exercises, targeted case studies, and detail-rich interpretations are interspersed throughout the video presentations.