

## Recently Issued Auditing Standards (RIAS4)



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## Contents for Today's Course

- Auditor Reporting
- Significant Unusual Transactions
- Audit Evidence
- Risk Assessment
- Engagement Quality

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# Unit 1 Auditor Reporting

KAPLAN



## Learning Objectives

- Upon completion of this unit the participant will be able to:
  - Identify the changes in the Independent Auditor's Report
  - Modify the Independent Auditor's Report for certain circumstances
  - Implement these standards on audits of financial statements.

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## Recently Issued Standards

- SAS 134—*Auditor Reporting & Amendments Addressing Disclosures in the Audit of Financial Statements*
- SAS 135—*Omnibus Statement on Auditing Standards-2019*
- SAS 136—*Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*
- SAS 137—*Auditor Responsibilities Relating to Other Information Included in the Annual Report*
- SAS 138—*Amendments to the Description of the Concept of Materiality*
- SAS 139—*Amendments to AU-C Sections to incorporate changes from SAS 134-137*
- SAS 140—*Amendments to AU-C Sections to incorporate changes from SAS 134-137*
- SAS 141—*Extension of Implementation Date of SAS 134-140*

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## Recently Issued Standards

- SAS 142—*Audit Evidence*
- SAS 143—*Auditing Accounting Estimates*
- SAS 144—*Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained from External Information Sources*
- SAS 145—*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- SAS 146—*Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*
- SAS 147 – *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*
- SAS 148 – *Amendment to AU-C Section 935*
- SAS 149 – *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*

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## Organization of Standards

- Four of the newly issued standards impact the independent auditor's report.
- Major changes are addressed in SAS 134.
- SAS 137 relates to the auditor's responsibilities regarding other information included in annual reports. This SAS may result in an additional paragraph in the independent auditor's report.
- SAS 138 changes the definition of materiality, not in substance, but to conform to the International Auditing and Assurance Standards. The new wording is incorporated in the Independent Auditor's Report.

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## Organization of Standards

- SAS 139 – conforming changes to the AU-C sections dealing with special purpose frameworks, single purpose financial statements and specific elements, accounts, or items of financial statements, and summary financial statements.
- SAS 140 – conforming changes to AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole, Required Supplementary Information and Interim Financial Information*.
- AU-C 930 revises the standard on Interim financial information for these changes. Auditors will want to consult the standard for the appropriate wording changes.

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## Organization of Standards

SAS 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* is perhaps the most comprehensive standards of the set. (AU-C 703)

- Standard includes new requirements that impact every part of an audit of ERISA plan financial statements.
  - Engagement acceptance
  - Risk assessment and response
  - Communication with those charged with governance
  - Performing procedures
  - Reporting
- The standard addresses, in a more robust way, the requirements previously only discussed in the AICPA's Accounting & Audit Guide on Employee Benefit Plans.
- One significant change to the employee benefit plan audit is to what was referred to as the "limited scope" audit.

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## Organization of Standards

- Management may still elect to have this type of audit if certain requirements are met.
- New terminology is an ERISA section 103(a)(3)(C) audit.
- Additions to the auditor's report provide greater transparency about the scope and nature of the audit and describe the procedures performed on the certified investment information.
- Auditor no longer issues a disclaimer of opinion but issues two opinions that
  - Amounts and disclosures in the accompanying financial statements, other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America.
  - Information in the accompanying financial statements related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).
- Auditors will want to consult SAS 136 (AU-C 703) for the appropriate wording changes to all reports

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## Organization of Standards

SAS #	Name of Pronouncement	Major Sections Affected
SAS 134	Auditor Reporting & Amendments Addressing Disclosures in the Audit of Financial Statements	AU-C 700 AU-C 701 (NEW) AU-C 705 AU-C 706
SAS 137	Auditor Responsibilities Relating to Other Information Included in the Annual Reports	AU-C 720
SAS 138	Amendments to the Description of the Concept of Materiality	AU-C 200 AU-C 320 AU-C 450
SAS 136	Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA	AU-C 703 (NEW)
SAS 139	Amendments to AU-C Sections to incorporate changes from SASs 134-137	AU-C 800 AU-C 805 AU-C 810
SAS 140	Amendments to AU-C Sections to incorporate changes from SASs 134-137	AU-C 725 AU-C 730 AU-C 930 AU-C 935 AU-C 940

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## SAS 134, Auditor Reporting

Changes	Description
Sections of the report have shifted	The opinion is presented first in order to draw the reader's attention to the conclusion. The basis for opinion comes next. There is an additional emphasis on the auditor's relation to the client and perspective on the financial statement audit. The report refers to the fact that the auditor is independent with respect to the audited entity. In addition, the report includes a statement that the auditor is required to meet his/her ethical responsibilities in accordance with the relevant ethical requirements related to the audit.
Going concern	The report describes management's responsibilities related to going concern when required by the financial reporting framework along with management responsibilities.
Additional description of auditor's responsibilities	The additional language mentions professional judgment, professional skepticism, and the auditor's communications with governance.

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## Components of SAS 134

Modification to the auditor's opinion	This element amends AU-C 705 and presents the various modifications that are possible when the auditor is unable to render an unmodified opinion (qualified, adverse, disclaimer). No changes were made to when these alternate opinions should be rendered.
Emphasis of a matter paragraph	This element amends AU-C 706. It clarifies the distinction between this paragraph and KAMs. If an auditor is engaged to report KAMs then the emphasis of matter paragraph cannot be a substitute for it if the matter meets the definition of a KAM. The heading must contain the words "Key Audit Matters" when referencing KAMs.
Other amendments	SAS 134 contains various amendments to the application material that address disclosures in the audited financial statements. These are not new requirements, merely additional application material designed to focus on the challenges in complex disclosures. These amendments affect AU-C 315, AU-C 330, and AU-C 700.

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## Independent Auditor's Report

### Opinion

We have audited the financial statements of Joe's Adventure Company, 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.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Joe's Adventure Company 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.

### 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 Joe's Adventure Company 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.

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## 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.

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 Joe's Adventure Company's ability to continue as a going concern for one year.**

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## Independent Auditor's Report

### 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.** ★

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## Independent Auditor's Report

### Auditor's Responsibilities for the Audit of the Financial Statements (cont.)

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 **Joe's Adventure Company's** internal control. Accordingly, no such opinion is expressed.

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## Independent Auditor's Report

### Auditor's Responsibilities for the Audit of the Financial Statements (cont.)

In performing an audit in accordance with GAAS, we:

- 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 Joe's Adventure Company'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.**

Wayne, Martin & York  
Tampa, FL  
April 22, 20X1

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## Modifications to Report

- **AU-C 705** contains the modifications to the auditor's report. (qualified opinions, adverse opinions, and disclaimers of opinion using the format and language established in SAS 134)
- **AU-C 706** addresses emphasis of a matter and other-matter paragraphs in the independent auditor's report.
- The auditor includes an emphasis-of-matter paragraph when required by GAAS or when the auditor wants to refer to a matter presented or disclosed in the financial statements that is important to users' understanding of the financial statements.
- The auditor includes an other-matter paragraph when required by GAAS, or when there is a matter other than those presented or disclosed in the financial statements that is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

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## Modifications to Report

- AU-C 706 does not require a specific order for the paragraphs
- When the auditor is engaged to report on Key Audit Matters, if there is a need for an emphasis-of-matter paragraph, it could be presented either directly before or after the “Key Audit Matters” section.
- When the auditor presents a “Key Audit Matters” section in the report and wants to also present an other-matter paragraph, they could add context to the heading “Other Matter”, adding additional words.
- For example, “Other Matter — Scope of the Audit,” could be used to differentiate the other-matter paragraph from the matters described in the “Key Audit Matters” section.

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## Key Audit Matters

- Auditor must be engaged to report on KAMs
- KAMs – intended to provide more transparency about the audit and give the users of the statements a basis to further engage with management and those charged with governance
- KAMs are only communicated when the auditor has formed an opinion on the financial statements
- When the auditor issues an adverse opinion, he/she is precluded from reporting on KAMs unless required by law or regulation

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## Key Audit Matters

- Reporting of KAMs is not a substitute for disclosures that are required by the financial reporting framework or otherwise needed for fair presentation
- KAMs cannot be viewed as a substitute for the auditor expressing a modified opinion or reporting as required by professional standards on the entity's ability to continue as a going concern
- KAMs are not a substitute for a separate opinion on individual matters
- Areas of higher risk of material misstatement or significant risks which were identified in the risk assessment process
- Significant auditor judgments relating to management's judgments or estimates that have high estimation uncertainty
- The effect on the audit of significant events or transactions

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## Key Audit Matters

- If the auditor concludes that there are no key audit matters to communicate or that the only key audit matters communicated are related to going concern or matters that lead to a qualification of the auditor's report they should include a statement to that effect in what would have been the "Key Audit Matter" section of the report.
- The auditor will also communicate the KAMs to those charged with governance or if there were none, provide them with that information.

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## Changes to Other Professional Standards

- **Communications to Governance** – Auditor has a responsibility to communicate the significant risks noted in the audit to governance. This is important for auditors to note because it may cause them to communicate information that has not been communicated before in **planning**.
- **Amendment to Going Concern Standard** – Separate paragraph needed when there is a substantial doubt about the entity's ability to continue as a going concern. The heading in the report will now be "Substantial Doubt About the Entity's Ability to Continue as a Going Concern".

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## Question for Discussion

The auditor's report as described in SAS 134 contains all but which one of the following items?

- A. More discussion about the auditor's responsibilities.
- B. A requirement to always have a separate paragraph about the entity's ability to remain a going concern for a reasonable period of time.
- C. Discussion about management's responsibility for assessing the entity's ability to remain a going concern for a reasonable period of time.
- D. The opinion section up front.

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## Question for Discussion, Solution

The auditor's report as described in SAS 134 contains all but which one of the following items?

- A. More discussion about the auditor's responsibilities.
- B. A requirement to always have a separate paragraph about the entity's ability to remain a going concern for a reasonable period of time.**
- C. Discussion about management's responsibility for assessing the entity's ability to remain a going concern for a reasonable period of time.
- D. The opinion section up front.

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## Unit 2 Significant Unusual Transactions

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## Learning Objectives

- Upon completion of this unit the participant will be able to:
  - Identify the changes brought about by SAS 135
  - Implement those changes in audits of financial statements

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## SAS 135 – Omnibus Standard

SAS 135	Omnibus Statement on Auditing Standards – 2019	AU-C 210, AU-C 240, AU-C 260 AU-C 265, AU-C 315, AU-C 330 AU-C 510, AU-C 550, AU-C 560 AU-C 600, AU-C 930, AU-C 940
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- Major changes to:
  - AU-C 240, *Consideration of Fraud in a Financial Statement Audit*;
  - AU-C 260, *Communication with Those Charged with Governance*; and
  - AU-C 550, *Related Parties*
- Standard adds questions and procedures for the auditor to perform.

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## SAS 135 – Omnibus Standard

- **AU-C 210, Terms of Engagement** – Inquire about the predecessor auditor's understanding of the entity's relationships and transactions with related parties and significant unusual transactions
- **AU-C 265, Communicating Internal Control Deficiencies** – Wording was added to correspond with the references to significant unusual transactions
- **AU-C 315, Understanding the Entity, and its Environment and Assessing the Risks of Material Misstatement**
- **AU-C 330, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained**
- **AU-C 510, Opening Balances** – Conform to add the need to identify related party transactions and significant unusual transactions

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## SAS 135 – Omnibus

- **AU-C 580, Written Representations** – Adds a **new representation**, i.e., whether any **side agreements or other arrangements** (either written or oral) exist that have **not been disclosed** to the auditor. Also consider for additional representations, if applicable, related to support for any assertion that a transaction was conducted at arms-length
- **AU-C 560, Subsequent Events** – Adds inquiries about whether there have been **changes** in the entity's related parties, significant related party transactions or significant unusual transactions
- **AU-C 600, Group Audits** – Adds requirement for **group engagement team to communicate its requirements to the component auditor including a list of related parties provided by group management**
- **AU-C 930, Interim Financial Reporting** – Conforming terminology, representations as discussed in AU-C 580
- **AU-C 940, Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements** – Conforming terminology, significant unusual transaction

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## Communication with Predecessor Auditors

SAS 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*, aims to improve communication between auditors when a client changes audit firms. Here's a breakdown of the key changes:

- Emphasizes the importance of inquiring about potential fraud or noncompliance with laws and regulations (NOCLAR) before accepting an audit engagement obtain from those charged with governance information relevant to the audit
- Ask specifically about identified or suspected fraud: This includes potential fraudulent activities involving management, employees with critical roles in internal control, or other parties who might have caused material misstatements in the financial statements.
- The new auditor should also inquire about any instances of noncompliance, or suspected noncompliance, that came to the predecessor auditor's attention during the previous audit (excluding trivial matters).

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## Communication with Governance

Objectives:

- communicate clearly with those charged with governance the responsibilities of the auditor regarding the financial statement audit and an overview of the planned scope and timing of the audit
- obtain from those charged with governance information relevant to the audit
- provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process
- promote effective two-way communication between the auditor and those charged with governance

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## Communication with Governance

- Those charged with governance – person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity.
- Includes overseeing the financial reporting process.
- Governance may include management personnel such as executive members of a governance board or an owner-manager.
- The changes to the standard add new communications to enhance the quality of audits since those charged with governance play an important role in oversight of the audited entity.
- New requirement to communicate the potential effects of uncorrected misstatements on future period financial statements.

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## Significant Unusual Transactions

- Communicate to those charged with governance any significant unusual transactions
- No definition in the standard
- Practice Alert 5 provides some assistance
  - Transactions with unconsolidated related parties that seem outside the entity's business
  - Transactions with related special purpose entities
  - Overly complex
  - Large number of intercompany transactions
  - Management is placing more emphasis on the need for a particular accounting treatment than the underlying economics of the transaction

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## Significant Unusual Transactions

- Practice Alert 5 provides some assistance
  - Transactions that appear to be unusual given the auditor's understanding of company and environment
  - Involving previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the company under audit
  - Transactions that appear to be unusual given the auditor's understanding of the company and its environment

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## Significant Unusual Transactions – Example

### Related Party Transaction Not Disclosed to the Auditor or the Board

The auditor of a manufacturing entity obtained an understanding of the entity and its environment. While performing preliminary analytics she noted a increase in warehouse rental expense. She asked about the increase and was told it was a new lease. The lease was not on the lease schedule for evaluation as a new lease. The agreement showed a significant amount of warehouse space in a remote location. She remembered that when she performed the physical inventory count at the end of the fiscal year that the main warehouse had ample space because inventory levels were down. Her analytic showed a decrease in sales. The new lease space was approximately 30% higher per square foot than the main warehouse which was in the same building as the manufacturing plant, and 25% higher than the two smaller warehouses that were near the entity's main customers.

After some due diligence she discovered that the warehouse was owned by a company owned by the board chair. Further, the board did not formally approve the transaction. This was deemed to be a significant unusual transaction for discussion with governance.

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## Significant Unusual Transactions – Example

### Brake Plant Under Construction with Significant Number of Intercompany Transactions

An auditor was working on a first-year engagement of a start-up company that was building a plant to manufacture brakes for automobiles using a proprietary technology. During planning he reviewed the interim financial statements. Since the entity had not commenced operations there were no sales. Expenses consisted of legal and accounting fees, raw materials to begin production in the coming year and personnel costs.

Since the entity had constructed the building and was in the process of building the machinery to run the proprietary process there were significant expenditures on property, plant and equipment on the balance sheet. The consolidated financial statements showed that there were 9 companies, several of which were headquartered overseas. During the year there were wire transfers from the parent to the subs and from the subs to the parent. The wires had documentation stating that the transfers were related to payment of expenses paid by one company on another's behalf and reimbursements for those expenses. In addition, the intercompany accounts did not reconcile.

Even after explanation from the client there did not seem to be a business rationale for the complexity of this company. The Board consisted of the family members of the majority shareholder. The auditor considered the risk of fraud related to this significant unusual situation.

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## Significant Unusual Transactions

- Difficult matters
  - Requirement to communicate where the auditor has consulted outside the engagement team, matter is significant

### EXAMPLE – Difficult Matter

The auditor of a hospital system consulted with a reimbursement specialist on a significant contract with Medicare. The contract called for fixed payments and bonuses based on quality of patient care as defined in the Medicare regulations. The contract was for three years and called for periodic evaluation of the amount due to or from Medicare. These evaluation periods did not correspond with the audited entity's year end. Management was forthcoming with all the information they used to estimate the quality bonuses and provided the auditor with all correspondence with Medicare. The transaction was difficult to audit even with the client's cooperation. The auditor hired a specialist to provide the necessary expertise related to quality as defined by Medicare.

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## Significant Unusual Transactions

- Contentious matters
  - Requirement to communicate where the auditor has consulted outside the engagement team, matter is significant

### EXAMPLE – Contentious Matter

An accounting firm was the successor auditor to a company that served as a third-party administrator for worker's compensation claims. The prior auditor agreed with the client's position that the total of the claims processed was revenue and the cost of the claims processed was expense. The client was also paid a fee for processing claims. The successor auditor did not agree with that position and pointed out that the client was performing a service and the fee they received for performing the service was the revenue and the cost to process the claims and run the business was the related expense. The client was not happy about the position because although the net income was the same, the revenue was not. This was an important metric to the client. The discussion went on throughout the audit without resolution until the auditor informed management that a GAAP departure would be one way to resolve it. The client continued to pressure the auditor up until the financial statements deadline to meet debt covenants was only two days away. The client agreed to make the journal entry. However, the auditor thought it was important to communicate this matter in the governance letter.

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## Other Changes to AU-260

- Uncorrected misstatement – auditor should communicate the presence of uncorrected misstatements that could potentially cause future periods to be materially misstated even if they are not material to the financial statements at the time.

### Example

A service company's primary expense was payroll and related benefits. To retain employees the company had a policy that unused vacation and sick leave could be accumulated up to 40 hours a year. Employees could take that time in the next year or gift it to another employee who needed it for medical leave. In the event the employee was terminated, for any reason, the amount would be paid out to them in cash. In the early years of the company the amount was not material to the financial statements but as the company continued to grow the accrual became larger. The auditor knew that an acquisition of another company was likely to occur in next year or two. This meant that the accrual could become material. Even though the accrual was not material in the current year, the auditor communicated the situation to governance.

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## AU-C 550, Related Parties

- Amended to include guidance from PCAOB AS 2410
- Intended to enhance the quality of audits
- Enhanced requirements to identify previously unidentified or undisclosed related party transactions and tests for accuracy and completeness
- Communicate with those charged with governance

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## AU-C 550, Related Parties

Inquiries During Risk Assessment Process (AU-C 315)	Additional Procedures to Perform (AU-C 330)
<p>Enhanced inquiries to management and others within the entity:</p> <ul style="list-style-type: none"> <li>• The nature of the relationships (<i>including ownership structure</i>) between the entity and the related parties.</li> <li>• <i>The business purpose of entering into a transaction with a related party versus an unrelated party.</i></li> </ul> <p>Whether the entity entered into, <i>modified, or terminated</i> any transactions with the related parties during the period and, if so, the type and <i>business</i> purpose of the transaction.</p>	<ul style="list-style-type: none"> <li>• Evaluate whether the entity has properly identified its related party relationships and transactions.</li> <li>• Perform procedures to test the accuracy and completeness of the related party relationships and transactions identified by the entity, considering information obtained during the audit.</li> <li>• Perform procedures on balances with affiliated entities as of concurrent dates, even if fiscal years of the respective entities differ</li> <li>• Perform additional procedures if necessary.</li> </ul>

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## AU-C 550, *Related Parties*

### Inquiries During Risk Assessment Process (AU-C 315)

The auditor should make these additional inquiries of management and others:

- Are there transactions that have not been authorized and approved in accordance with the entity's established policies or procedures regarding the authorization and approval of transactions with related parties?
- Are there transactions where exceptions to the entity's established policies or procedures were granted and the reasons for granting those exceptions?

Inquiries to those charged with governance:

- Their understanding of the entity's relationships and transactions with related parties that are significant to the entity
- Whether any of those charged with governance have concerns regarding relationships or transactions with related parties. If so, what are the concerns?

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## AU-C 240 Consideration of Fraud

Auditor should consider the risks of fraud where:

- Transactions that involve previously unidentified related parties or **relationships or transactions** with related parties previously undisclosed to the auditor.
- Transactions involving other parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit or any related party of the entity.
- Transactions lack commercial or economic substance or are part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance (both individually and in the aggregate)
- Transactions that are entered into shortly prior to period end and that are unwound shortly after period end.
- Transactions occur with a party that falls outside the definition of a related party (as defined by the applicable financial reporting framework), with either party able to negotiate terms that may not be available for other, more clearly independent parties on an arm's-length basis.
- Transactions exist to enable the entity to achieve certain financial targets.

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## AU-C 240 Consideration of Fraud

### Example

Transaction with Related Party Where there was a Question about a Significant Receivable

The majority owner of a nursing home company (auditee) also owned several nursing homes outside the company which were not audited. The auditor noted a note receivable on the books in the amount of \$5,000,000 which was material. It was from the owner. The note carried a market rate of interest and was collateralized by one of the nursing homes held outside the company. It did not call for payments and there was no maturity date.

The company was a privately held and the governing board consisted of family members. The company also had an employee stock ownership plan (ESOP) and shares were held by the employees of the company. The auditor identified this as a significant unusual transaction. Substantive testing of the valuation of the collateral provided evidence that the collateral was sufficient to cover the note in the event of default. The auditor's assessment was that there was no indication of fraud.

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## AU-C 240 Consideration of Fraud

- Incorporates changes related to significant unusual transactions and related parties
- Adds them into inquiries and other procedures
- New procedures to evaluate when transactions outside the normal course of business are identified
  - Evaluate the rationale and business purpose for those transactions
  - Read the supporting documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence
  - Determine whether the transaction has been authorized and approved
  - Evaluate whether significant unusual transactions identified have been properly accounted for and disclosed in the financial statements

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## Question for Discussion

As discussed in SAS 135 the auditor is required to communicate significant unusual matters to those charged with governance. Which one of the following is correct?

- A. There is no specific discussion in the standard as to what constitutes an unusual matter.
- B. The PCAOB did not amend its similar standard to define significant unusual matter.
- C. The PCAOB issued a Practice Alert with examples of significant unusual matters.
- D. All of the above are correct.

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## Question for Discussion, Solution

As discussed in SAS 135 the auditor is required to communicate significant unusual matters to those charged with governance. Which one of the following is correct?

- A. There is no specific discussion in the standard as to what constitutes an unusual matter.
- B. The PCAOB did not amend its similar standard to define significant unusual matter.
- C. The PCAOB issued a Practice Alert with examples of significant unusual matters.
- D. **All of the above are correct.**

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## Unit 3 Audit Evidence



### Learning Objectives

- Upon completion of this unit the participant will be able to:
  - Identify the characteristics of sufficient appropriate audit evidence
  - Apply the procedures required when using the work of management's specialist, the auditor's specialist and a pricing service as audit evidence
  - Identify the enhanced requirements related to auditing accounting estimates
  - Identify the enhanced requirements related to the use of audit evidence in a financial statement audit

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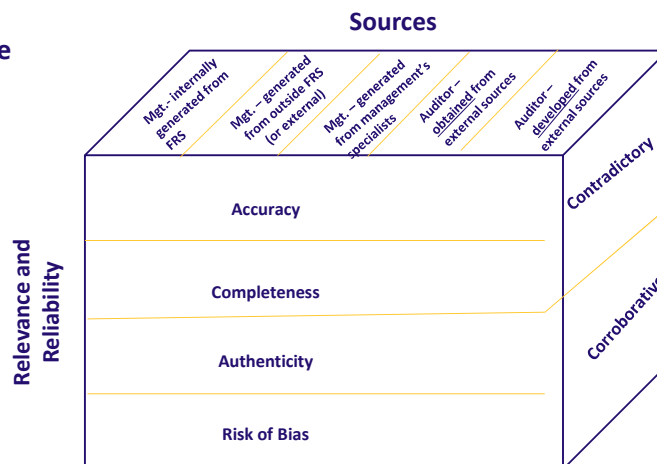
## SAS 142, Audit Evidence

- AU-C 500 has not been significantly revised even though clarified in 2011
- Complexity in the environment
- Technological advances
- Concern over lack of professional skepticism
- Standard addresses emerging technologies, professional skepticism, management specialists, and audit documentation
- Newer technologies, although given as examples in the standard are not described in detail
- SAS 142 on audit evidence should be read in conjunction with other standards

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## SAS 142, Audit Evidence

### Evidence Cube



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## Question for Discussion

Which is one of the primary purposes of the standard on audit evidence?

- A. To address diversities in practice as it relates to audit evidence.
- B. To modernize the guidance and address the changes in techniques and sources of evidence made possible by technological advances.
- C. To address the complexities brought about by recent FASB pronouncements.
- D. To address deficiencies found by peer reviewers and governmental agencies.

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## Question for Discussion, Solution

Which is one of the primary purposes of the standard on audit evidence?

- A. To address diversities in practice as it relates to audit evidence.
- B. To modernize the guidance and address the changes in techniques and sources of evidence made possible by technological advances.**
- C. To address the complexities brought about by recent FASB pronouncements.
- D. To address deficiencies found by peer reviewers and governmental agencies.

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## SAS 142, *Audit Evidence*

- **Relevance** – The factors that affect the relevance of information are:
  - The objective of the procedures to be performed as well as the assertions;
  - The account balances, classes of transactions or disclosures to which the information relates; and
  - Period of time to which the information relates

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## Relevance

### EXAMPLE

An audit senior was testing the relevant assertions for accounts receivable and revenue. She sent out confirmations to the largest accounts to determine whether the balances existed. She also evaluated subsequent receipts to evidence the amount being paid and that it existed at the balance sheet date. The audit manager asked her to go back and perform a test of valuation by looking at the aging report and evaluating how many of those balances were paid. She also asked her to look in hindsight to determine if the allowance for bad debts was adequate in the prior year. Finally, she asked her to consider the aging of the receivables given the historical knowledge of the client's ability to estimate as well as any current conditions identified during the risk assessment process. These procedures, however, did not test completeness of revenue and receivables. The auditor generally tests debit balances (receivable) for overstatement and credit balances (revenue) for understatement. Analytical procedures are very helpful in this regard. The manager assisted the audit senior in developing an appropriate substantive analytical procedure (SAP).

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## **SAS 142, Audit Evidence**

- **Reliability** – The factors that affect the reliability of information are:
  - Accuracy;
  - Completeness;
  - Authenticity; and
  - Risk of bias
- Internal controls: internal information is considered more reliable when internal controls over the accumulation, preparation and maintenance of the information have been tested. Inquiry alone is not sufficient to test internal controls

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## **SAS 142, Audit Evidence**

**Reliability** of information is affected by accuracy, completeness, authenticity, and the risk of bias.

- **Internal controls** – The auditor’s judgment and professional skepticism play a significant role in the consideration of reliability.
- Information is more reliable when controls over its accumulation, preparation and maintenance have been tested.
- The auditor is responsible for an understanding of the five levels of internal control including identified control activities over relevant assertions.
- Controls over the preparation of internal reports that the auditor will use in testing, or controls over how information is accumulated, prepared ,and maintained at a service organization leads to reliability.

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## SAS 142, Audit Evidence

- **Management bias** – There is a higher risk of management bias when information comes from internal sources. Consider:
  - The ability of the entity to influence the external information source;
  - Management’s selection of information so that it “proves” management’s assertions; and
  - Management’s unknowing use of information from an external source that is biased.

### EXAMPLE

An auditor was evaluating an estimate prepared by the client for the valuation of amounts for self-insured risks. The partner on the engagement realized that this estimate had more risk of bias either because had a sense that the risks that had been identified by the quality and safety department as being potential liabilities would not occur since that the company would rigorously defend them. The auditor knew that in the past the client’s optimism about outcomes had been misguided and additional evidence would be needed to assess the client’s estimate.

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## SAS 142, Audit Evidence

### Auditor bias

- **Availability bias** – The auditor chooses information that is easily retrievable as being more likely, more relevant, and more important for a judgment.
- **Confirmation bias** – The auditor looks for information that is consistent with initial beliefs or preferences.
- **Overconfidence bias** – The auditor overestimates his/her ability to make accurate assessments. For example, in the case of complex financial instruments the auditor does not seek outside assistance to assist in evaluating an assertion.
- **Anchoring bias** – The auditor assesses an account balance by starting with a number and not adjusting far enough away from the initial value.

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## **SAS 142, Audit Evidence**

- Accuracy and completeness
  - Auditors should reconcile the population from which samples are chosen or data is drawn for analytical procedures to the general ledger
  - Tests of controls are another good way to support accuracy and completeness
- Authenticity
  - Auditors are not document authentication specialists

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## **SAS 142, Audit Evidence**

### **Sources of evidence:**

- From management – Generated internally from the financial reporting system;
- From management – Generated outside the financial reporting system, including from sources external to the entity;
- From management – Obtained from management's specialists;
- Auditor – Obtained from sources external to the entity;
- Auditor – Developed from sources internal or external to the entity

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## EXAMPLE

An auditor of an entity with a defined benefit pension plan was evaluating audit evidence used by management in their estimate of the accumulated benefit obligation. Some of the information involved in the calculation was generated internally from the financial reporting system. Other information was provided by an actuary, who was considered one of management's specialists. The auditor tested that information by obtaining, understanding, and testing the accumulation of data provided to the actuary by management. Then the auditor tested the information provided by the actuary using the audit guidance in AU-C 620, *Use of an Auditor's Specialist*, that is relevant when management uses a specialist.

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## SAS 142, *Audit Evidence*

- **Internal information** – In the past much of it was in paper form but today a significant amount is in electronic form
- Auditors have used computer-aided audit techniques on internal data to perform procedures for many years
- Audit data analytics is a technique that analyzes patterns, identifies anomalies or extracts information from data through analysis, modeling or visualization
- Automated techniques are used to foot journals or ledgers for accuracy, scan data to identify anomalies, and select samples for testing

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## Question for Discussion

The auditor is concerned with the possibility of bias coming from:

- A. Auditor only
- B. Management only
- C. Those charged with governance only
- D. Management and the auditor

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## Question for Discussion, Solution

The auditor is concerned with the possibility of bias coming from:

- A. Auditor only
- B. Management only
- C. Those charged with governance only
- D. Management and the auditor**

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## **SAS 142, Audit Evidence**

- Typical uses of the automated techniques in the past have been to:
  - Foot journals and ledgers to determine accuracy;
  - Choose journal entries;
  - Scan data to identify anomalies;
  - Identify samples for testing; and
  - Perform regression analysis
- Data analytics can be used effectively to perform more sophisticated data queries and then portray the data visually so that patterns can be seen more easily
- This adds value to the auditor's work and to the client

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## **SAS 142, Audit Evidence**

- These more sophisticated analytics are not without risk. If the data is not relevant and reliable the test will not provide appropriate evidence
- Auditors should consider the need for tests of controls or tests of accumulation of information to provide evidence of reliability of the data used
- They also need to be skilled in understanding the client's business to ensure that the right data is used and skilled in the application used to perform the test

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## **SAS 142, Audit Evidence**

- SAS 142 mentions these other techniques but does not describe them in detail
- **Artificial intelligence (AI)** – AI is a set of algorithms that perform work that traditionally requires human intelligence
  - Algorithms are created to classify, analyze, and draw predictions from data
  - There are a number of different AI applications that involve acting on data, learning from new data, and improving predictability over time
  - AI can be simple or very complex
  - Some of the simpler examples are Google Search, Alexa, Siri and other personal assistants, and image recognition software

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## **SAS 142, Audit Evidence**

- **Machine learning** is a type of AI that feeds a computer with data and uses statistical techniques to help it "learn" how to get progressively better at a task
  - Example: A user feeds a computer with large amounts of data on sales and advertising dollars spent. Machine learning is used to see the patterns in data and make predictions of future sales based on dollars spent
  - Another useful application is the use of computer vision to read and analyze complex contracts
- **Remote observation** tools such as drones can be used for many applications such as to count inventory in difficult to reach places

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## **SAS 142, Audit Evidence**

- **Robotic process automation** is a technology application that automates routine business
  - Tool captures and interpreted applications for processing transactions, manipulating data, triggering responses and communicating with other digital systems
  - Applications of RPA can be very simple. For example, a robot can be created that generates an automatic response to an email
  - Some applications take routine business processes and automate them
  - RPA can be constructed to take an electronic invoice, match it to a purchase order and receiving documents, and either approve or reject it until discrepancies can be resolved
  - Auditors can use RPA to streamline repeatable processes as well

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## **SAS 142, Audit Evidence**

- External information – auditor may have less access to determine reliability and may be biased to believe that since the information is external to the client it is automatically reliable.
- Distinction between external sources and sources that are specifically relevant to the client.
- External sources could be pricing services, governments, central banks, stock exchanges, media, or academic journal.
- External source is not a management's specialist, a service organization, or an auditor's specialist.
- Entity or individual acting as a specialist or service organization may fill more than one role and professional judgment may be necessary to determine the capacity in which the person or organization is acting at a particular time.

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## EXAMPLES

Actuaries are frequently involved in valuations such as pension liabilities or claims payable. In this context the actuary is not an external source. When actuarial firms publish data on mortality or other information they are functioning as external sources.

Valuation specialists use models such as Black Scholes to estimate the value of derivative instruments. In this case if the service is performed for a client, the specialist is acting as management's specialist. But if a valuation firm prepares information for the public and an entity uses it in an estimation then the valuation firm is an external source.

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## **SAS 142, *Audit Evidence***

- Auditors consider relevance and reliability of external information regardless of if the auditor or management obtained it
- Information about the external information source or the preparation of the information by the external information source
- Audit evidence obtained through designing and performing further audit procedures
- Why management or, their specialist uses an external information source, and how the relevance and reliability of the information was considered so that the auditor can consider those attributes or variables
- The nature and authority of the external information source

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## **SAS 142, Audit Evidence**

- The ability of management to influence the information obtained, through relationships between the entity and the external information source
- The competence and reputation of the external information source with respect to the information
- Past experience of the auditor with the reliability of the information provided by the external information source
- Evidence of general market acceptance by users of the relevance or reliability of information from an external information source for a similar purpose to that for which the information has been used by management or the auditor
- Whether the entity has in place controls to address the relevance and reliability of the information obtained and used

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## **SAS 142, Audit Evidence**

- Whether the information is suitable for use in the manner in which it is being used
- Alternative information that may contradict the information used
- Nature and extent of disclaimers or other restrictive language relating to the information;
- Information about the methods used in preparing the information and how the methods are being applied including, where applicable, how models have been used in such application, and the controls over the methods: and
- Information relevant to considering the appropriateness of assumptions and other data applied by the external information sources in developing the information obtained.

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## Question for Discussion

Regression analysis is a very popular data analysis technique that can be used to do which of the following?

- A. Model the relationship between a dependent and independent variable. It can be used to predict account balances by identifying anomalies in a data set.
- B. Choose samples for substantive testing.
- C. Test 100% of a population by scanning for unusual items.
- D. Test a population for completeness.

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## Question for Discussion, Solution

Regression analysis is a very popular data analysis technique that can be used to do which of the following?

- A. Model the relationship between a dependent and independent variable. It can be used to predict account balances by identifying anomalies in a data set.**
- B. Choose samples for substantive testing.
- C. Test 100% of a population by scanning for unusual items.
- D. Test a population for completeness.

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## SAS 142, Audit Evidence

- Auditors should consider:
  - Information about the methods used in preparing the information;
  - How the methods are being applied, including how models have been used in such application, and the controls over the methods; and
  - Information relevant to considering the appropriateness of assumptions and other data applied by the external information source
- If the auditor has doubts about the reliability of the information, they may decide to perform a comparison of the information obtained from the external source with information obtained from another independent information source
- The auditor could also consider obtaining an understanding of management's controls over the reliability of external information and perhaps even test them
- If the auditor does not have a sufficient basis to consider the relevance and reliability of information from an external information source, it could mean that there is a scope limitation

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## SAS 142, Audit Evidence

Types of Evidence	Considerations
Oral evidence	Oral inquiries are made during the audit to internal sources such as management or to external sources such as attorneys. Inquiries should be backed up with other forms of evidence.
Visual information	Auditors use observation in risk assessment procedures such as understanding an entity's internal control. Observation is also used in connection with physical inventories. For example, an auditor could observe a message that appears on client personnel's computer screen evidencing restricted access to an IT application. Drones or video technology could be used as remote observation tools to facilitate inventory observations.
Paper documents	Although this used to be the most prevalent form of evidence entities are not embracing electronic documentation and using services such as DocuSign instead of handwritten signatures.

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## SAS 142, Audit Evidence

Types of Evidence	Considerations
Electronic information	This is becoming prevalent. Many documents that at one time were presented to the auditor in paper form are now electronic and this trend will continue. Paper documents such as a paper contract can be scanned. When information is transformed from its original state, whether its scanned, filmed, digitized, or transformed by other means, the data may lose its reliability. Therefore, the auditor may need to perform additional audit procedures to address the reliability of the data such as inspection of the original documents or tests of internal controls over the transformation and maintenance of the information.
Data	Data that is stored in the entity's IT system or obtained from an external source may be either manually input into the system or electronically generated. For example, there is often an electronic interface between an entity and a service organization which is used to transmit data.
Client records	Client records may be in paper or electronic form. This includes ledgers, spreadsheets, cost allocations, reconciliations, accounting entries, etc.
Information from published sources	The auditor may use information from trade groups or government agencies often in combination with information from management.

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## SAS 142, Audit Evidence

- When the auditor forms a conclusion about whether sufficient evidence has been obtained, they should consider **all** the evidence no matter if it corroborates or contradicts the assertions.
- Contradictory and corroborative information is considered together not in isolation.
- Sometimes the absence of information is used by the auditor and constitutes evidence.

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## **SAS 142, Audit Evidence**

### **Corroborative or Contradictory Information**

An auditor was auditing a financial institution with an extensive portfolio of loans secured by real estate in one geographic area. The auditor obtained industry information about the market where the real estate was located that contradicted the appraisals management gave the auditor to support the value of the collateral. The auditor had to perform additional procedures to reconcile the difference.

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## **SAS 142, Audit Evidence**

- Audit evidence obtained by:
- performing risk assessment procedures
- tests of controls (when required or when the auditor chooses to perform them)
- substantive procedures (tests of details and SAPs).
- If information is available only in electronic form or only at certain points or periods in time this can impact the auditor's testing strategy.

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## **SAS 142, Audit Evidence**

- If the entity's data retention policies are not long enough the auditor may need to request that the client retain certain information during the year so that it can be used either later or the auditor may choose to perform procedures when the data is available.
- Other electronic information such as records maintained on a blockchain is available on a continuous basis during the audit.

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## **SAS 142, Audit Evidence**

- Audit procedures:
  - Inspection (text recognition programs can be used to examine documents);
  - Observation (use of drone technology);
  - External confirmation;
  - Reperformance;
  - Recalculation (use of technology to recalculate); and
  - Inquiry

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## SAS 142, Audit Evidence

- Analytical procedures and use of data analytics
  - Risk assessment procedures
  - Substantive testing

An auditor wanted to use audit data analytics as a risk assessment procedure to look for unusual transactions or events and amounts, ratios and trends that might indicate an area of higher risk. She found it easier to spot issues by looking at visualizations of transactional detail. She prepared an analytic of sales data displayed as a visual highlighting per unit values and number of items in a population. Although the procedure was primarily performed as a risk assessment procedure, the auditor determined that it yielded sufficiently precise information and the output could be used in a substantive analytical procedure as well.

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## Question for Discussion

Which of the following is true about SAS 142 on audit evidence?

- A. SAS 142 is likely to result in the auditor performing tests of the completeness and accuracy of the data in reports used in performing analytical procedures.
- B. SAS 142 has extensive coverage on how to test blockchain and robotic process automation.
- C. SAS 142 makes significant changes to the types of procedures used for audit evidence.
- D. SAS 142 is effective beginning with calendar year ends 2023.

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## Question for Discussion, Solution

Which of the following is true about SAS 142 on audit evidence?

- A. **SAS 142 is likely to result in the auditor performing tests of the completeness and accuracy of the data in reports used in performing analytical procedures.**
- B. SAS 142 has extensive coverage on how to test blockchain and robotic process automation.
- C. SAS 142 makes significant changes to the types of procedures used for audit evidence.
- D. SAS 142 is effective beginning with calendar year ends 2023.

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## SAS 144, Use of Specialists and Pricing Information

- SAS 144 amends three AU-C sections
  - AU-C 501, Audit Evidence, Specific Considerations for Selected Items,
  - AU-C 540, Auditing Accounting Estimates
  - AU-C 620, Using the Work of an Auditor's Specialist
- Effective for periods ending on or after December 15, 2023.
- Standard issued primarily to respond to feedback asking for additional guidance on auditing the fair value of financial instruments
- Pricing services are extensively used in the area of investments, also causing an interest for the ASB to pursue this topic.

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## SAS 144, Use of Specialists and Pricing Information

- Provides guidance in on applying SAS No. 143, when management has used the work of a specialist in developing accounting estimates.
- Provides enhanced guidance about evaluating the work of management's specialist and an auditor's specialist.
- Adds a new appendix that provides guidance on the use of pricing information from pricing services when evaluating management's estimates related to the fair value of financial instruments.

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## Using the Work of Management's Specialist

- AU-C 501 addresses the audits of certain topic areas such as investments, inventory, litigation, and assessments and using the work of management's specialist.
- **Management's specialist** – individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
- External inventory-taking firm is not management's specialist.
- Most aspects of the topic, use of management's specialist have **not** changed.

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## Using the Work of Management's Specialist

- If information to be used as audit evidence has been prepared using the work of a management's specialist, the auditor should, consider the significance of that specialist's work.
- If significant, the auditor should perform procedures to:
  - Evaluate the competence, capabilities, and objectivity of that specialist
  - Obtain an understanding of the work of that specialist
  - Evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion

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## Pricing Information From Third Parties

- Auditors may choose to use information from a third-party pricing service as evidence to support management's estimates on financial instruments
- Information from an external pricing service is more reliable than internal information because it is less susceptible to management bias
- When the auditor uses pricing information from an external information source to develop an independent expectation or evaluate pricing information provided by a third party used by the entity, they are required to perform procedures to evaluate that information
- The extent of the procedures is dependent on the nature of the information obtained
- When there is very little subjectivity, external published guidance from reputable sources may be sufficient

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## Pricing Information From Third Parties

### EXAMPLE

An auditor wanted to test the valuation assertion for testing a client's investment portfolio. The auditor was able to find quoted market prices for the derivative instruments and securities in the portfolio listed on national exchanges and OTC markets. The auditor obtained some of that information from stock exchanges, including NASDAQ. Some was obtained from external pricing services. Since this external information is generally available to the public and not prepared for a specific financial instrument which is not routinely priced, no further work is to be performed to support the fair value of the securities in the client's portfolio.

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## Pricing Information From Third Parties

- When information is provided by a pricing service and is routinely priced for subscribers to the service, the general guidance in AU-C 501 applies
- When a pricing service is engaged to individually develop a price for a specific financial instrument that is not routinely priced for its subscribers, use the guidance in AU-C 501 (use of management's specialist) or AU-C 620, *Using the Work of an Auditor's Specialist*

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## Pricing Information From Third Parties

- The auditor evaluates:
  - The experience and expertise of the pricing service relative to the types of financial instruments being valued
  - Whether the methodology used by the pricing service in determining fair value of the types of financial instruments being valued is in accordance with the entity's financial reporting framework
  - Whether management has the ability to influence the pricing service
- Just because subscribers can challenge a pricing service's pricing information does not, by itself, mean that management has the ability to influence that pricing service

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## Pricing Information From Third Parties

### Information provided as of an interim date

- Auditor should determine whether the pricing service has changed its valuation process relative to the types of financial instruments being valued during the period after the interim date evaluated
- Auditor should understand whether transactions have occurred subsequent to the time of valuation that may have an effect on the valuation as well as any change in methodology, including the inputs used in the assumptions related to the fair value estimate
- The extent of procedures will depend on the uncertainty involved

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## Pricing Information From Third Parties

- Fair values for securities with quoted market prices in an active market for identical financial instruments have lower risk than those in inactive markets or that have unobservable inputs
- When the fair values are based on transactions of similar financial instruments, then the audit procedures used could include evaluating how the transactions are identified, considered comparable, and then used in the valuation of the financial instruments the auditor is testing
- If the process used by the pricing service in pricing several similar financial instruments is the same, then the auditor can test them as a group

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## Pricing Information From Third Parties

- The auditor will want to evaluate the similarity of the financial instruments by looking at:
  - The terms and characteristics of the financial instruments
  - The extent to which the fair value of the type of financial instrument is based on inputs that are observable directly or indirectly
  - Other factors affecting the valuation of the financial instruments, such as credit or counterparty risk, market risk, and liquidity risk

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## Pricing Information From Third Parties

### Unobservable inputs

- Auditor should obtain an understanding of how those inputs were determined and evaluate their reasonableness
- Auditor should consider whether modifications made to observable information reflect the assumptions that market participants would use including those about risk and how management determined its fair value measurement
- If no recent transactions have occurred for either the financial instrument being valued or similar financial instruments, audit procedures may include evaluating the appropriateness of the valuation method and the reasonableness of observable and unobservable inputs used by the pricing service

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## Pricing Information From Third Parties

### Pricing information obtained from more than one pricing service

- If the valuations are comparable, less information may be needed about the methods and inputs used. Consider:
  - Recent trades of the financial instrument or of financial instruments substantially similar
  - Pricing services routinely price the financial instruments
  - Reasonably consistent prices across pricing services
  - Observable inputs
- If none of these factors are present, then the auditor may be required to perform further audit procedures

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## Pricing Information From Third Parties

- **Market Maker in the Stock**
- Auditor will want to determine whether that entity:
  - Has a relationship with management and the ability to influence the broker/dealer
  - Is a market maker that transacts in the same type of financial instrument
  - Has provided a quote that reflects market conditions as of the F/S date
  - Quote is binding on the broker or dealer
- The auditor should determine if there are any restrictions, limitations, or disclaimers in the broker quote and, if so, their nature
- Quotes provide better evidence when timely, binding quotes, without any restrictions, limitations, or disclaimers and when the broker is not a market maker
- If the broker quote does not provide sufficient appropriate audit evidence, then the auditor may need to perform additional procedures

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## Pricing Information From Third Parties

### EXAMPLE

An auditor was testing a client's portfolio that contained securities that were not actively traded. The client obtained pricing information from their broker to value the securities. The auditor made inquiries of the client about the broker and determined that the broker was a market maker for one of the securities. The auditor made plans to obtain information on that security from another pricing service.

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## Question for Discussion

In determining the relevance and reliability of audit information provided by a pricing service the auditor will consider:

- A. Whether the pricing service has a relationship with the entity and management has the ability to influence the pricing service
- B. The length of time the client has held the security
- C. The size of the client's position in the security
- D. Whether the client sold the security shortly after year end.

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## Question for Discussion, Solution

In determining the relevance and reliability of audit information provided by a pricing service the auditor will consider:

- A. Whether the pricing service has a relationship with the entity and management has the ability to influence the pricing service**
- B. The length of time the client has held the security
- C. The size of the client's position in the security
- D. Whether the client sold the security shortly after year end.

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## Using the Work of the Auditor's Specialist

- Auditor may engage a specialist to assist in addressing concerns about using the work of management's specialist due to:
  - Whether the management's specialist is employed by the entity or is engaged by it
  - Extent to which management can exercise control or influence over the specialist
  - Competence and capabilities of the management's specialist
  - Status of controls within the entity over the work of the management's specialist
  - Evaluation of the significance of threats to objectivity and of whether a need exists for safeguards
  - The auditor's ability to evaluate the work and findings of the management's specialist without the assistance of an auditor's specialist
- Auditor evaluates the objectivity of their specialist and ask if the specialist has had a role in preparing the subject matter or has other conflicts of interest

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## Using the Work of the Auditor's Specialist

- Auditor and the specialist should discuss and agree on their roles and responsibilities, including:
  - Who will perform detailed testing of source data
  - Degree of responsibility of the specialist for the testing of data produced by the entity, or evaluating the relevance and reliability of data external sources
  - Evaluating the significant assumptions
  - Evaluating the methods used by the entity or management's specialist
  - Consent for the auditor to discuss the findings of the auditor's specialist with the entity and others and include details of the findings or conclusions if report is modified
  - Agreement to inform the auditor's specialist of the auditor's conclusions concerning the work of the auditor's specialist

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## Using the Work of the Auditor's Specialist

- The auditor is responsible for **obtaining an understanding** of those assumptions and methods and evaluating the relevance and reasonableness of those assumptions and methods. The auditor will want to consider:
  - Whether the assumptions and methods are generally accepted within the field of the auditor's specialist
  - Whether the assumptions and methods are consistent with the requirements of the applicable financial reporting framework
  - Whether the work is dependent on the use of specialized models if the specialist's models are consistent with those of management. If they are not, the auditor will want to understand the differences and the effects on the estimate

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## Using the Work of the Auditor's Specialist

- If the work of an auditor's specialist involves the use of source data that is significant to the work of the auditor's specialist, the auditor should perform procedures
- Example – The auditor could verify the source of the data, understand or test the internal controls over the data and, when relevant, test the transmission of the data to the auditor's specialist
- The auditor will also want to review the data for completeness and internal consistency
- If the auditor determines that the work of the auditor's specialist is not sufficient, the auditor will need to consider use of another specialist or performing the work in some other way

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## Question for Discussion

Which of the following is **true** about using the work of a specialist?

- A. The auditor performs the same procedures regardless of whether they are using the work of management's specialist or one hired by the auditor.
- B. When using the work of a specialist the auditor is required to test internal control.
- C. The auditor will be able to use the work of an auditor's specialist without further procedures as long as they are hired by the auditor and independent of the client.
- D. The auditor and the specialist should agree on the roles so that the necessary work is performed on the subject matter but there is little overlap.

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## Question for Discussion, Solution

Which of the following is **true** about using the work of a specialist?

- A. The auditor performs the same procedures regardless of whether they are using the work of management's specialist or one hired by the auditor.
- B. When using the work of a specialist the auditor is required to test internal control.
- C. The auditor will be able to use the work of an auditor's specialist without further procedures as long as they are hired by the auditor and independent of the client.
- D. The auditor and the specialist should agree on the roles so that the necessary work is performed on the subject matter but there is little overlap.**

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- Revised, primarily to conform with the international standard dealing with accounting estimates.
- FASB has issued several accounting standards over the last few years that deal with estimates and disclosures including one that will soon be effective for all entities on credit losses.
- The task force also identified a need to foster more robust professional skepticism on the part of the auditor.
- Degree of estimation uncertainty varies widely from situation to situation.
- Standard is effective for years ending after December 15, 2023.

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- Estimation uncertainty – susceptibility of an estimate to an inherent lack of precision in measurement.
- Not possible to directly observe a monetary amount for the account balance
- Inherent limitations in knowledge or data
- Some estimates are simple, and others are complex
- Some accounting estimates that require the application of specialized skills or knowledge.
- Auditor will evaluate inherent risk in the estimates considering uncertainty, complexity, or other risk factors.

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## EXAMPLES

An auditor was considering a financial institution's reserve for credit losses. The model was complex and used historical data as well as assumptions about future developments. The knowledge and skill needed is entity-specific and losses are very difficult to predict. In addition, management's bias can play a role in the resulting estimate. The auditor realized that not only was this estimate complex it was subject to a high degree of estimation uncertainty and more audit work would be necessary for this estimate.

An auditor of a home health company was considering an estimate for a litigation contingency. The entity did not have a history of lawsuits the way that the auditor's other healthcare clients did, so management was not accustomed to making such an estimate. Since this estimate required a single critical judgment about a liability it was not a complex estimate although it had a high estimation uncertainty component.

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## Question for Discussion

When would an auditor be likely to assess the inherent risk over an estimate as high?

- A. When the estimate is on the useful lives of property, plant and equipment and the balance of the account is material.
- B. When management has developed a point estimate instead of a range.
- C. When the estimate is very subjective and has the assumptions are difficult to validate
- D. When controls over the estimate are weak.

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## Question for Discussion, Solution

When would an auditor be likely to assess the inherent risk over an estimate as high?

- A. When the estimate is on the useful lives of property, plant and equipment and the balance of the account is material.
- B. When management has developed a point estimate instead of a range.
- C. When the estimate is very subjective and has the assumptions are difficult to validate**
- D. When controls over the estimate are weak.

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

### **Risk assessment process**

- Inherent risk factors such as regulatory requirements or external events play a role
- Another factor is quality of entity's internal controls over management estimates
- Management bias is the lack of neutrality by management in the preparation of information.
- Not necessarily intentional.
- Management may have too high opinion of the ability of customers, clients, donors, etc. to pay.
- Could be a lack of understanding of the critical nature of accounting estimates to the user F/S.
- Could be a deliberate intent to misstate the financials to show an improved result
- Auditor should maintain a high degree of skepticism and challenge the documentation provided

120



## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- **Separate assessment of inherent and control risk**
- Inherent risk related to estimates is assessed considering:
  - The degree to which the accounting estimate is subject to estimation uncertainty;
  - The degree to which the selection and application of the method, assumptions, and data are affected in computing the accounting estimate; and
  - The selection of management's point estimate and related disclosures for inclusion in the financial statements
- Auditor should review the outcome of previous accounting estimates.
- Specialized skill may be needed.

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

### **Control Risk**

- Obtain understanding of internal controls:
  - Nature and extent of oversight and governance
  - How management identifies the need for and applies specialized skills or knowledge related to accounting estimates
  - How the entity's risk assessment process identifies and addresses risks relating to accounting estimates
  - Whether the estimates arise from recording routine, recurring transactions such as depreciation, or nonrecurring or unusual transactions
  - How the information system addresses the completeness of accounting estimates and disclosures relates particularly to liabilities

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- Obtain understanding of internal controls (cont.)
- How management identifies relevant methods, assumptions, or sources of data and how it:
  - Selects or designs and applies the methods and models used
  - Selects the assumptions to be used and significant assumptions
  - Selects the data to be used
  - Understands the degree of estimation uncertainty including possible outcomes
  - Addresses the estimation uncertainty
  - Reviews the outcomes of previous accounting estimates and responds to the results of that review

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

### **Enhanced Requirements**

- Special focus on how complexity, subjectivity, and estimation uncertainty are considered in identifying and assessing risks of material misstatement
- Auditor should perform a hindsight review to evaluate the outcome of previous accounting estimates or, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period
- Consider the characteristics and inherent risk in determining the nature and extent of that review
- More risk could lead to a need for specialized skills or knowledge
- Once the auditor has assessed the risk of material misstatement, including any significant risks, they should design and perform tests responsive to those risks

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## **SAS 143, Auditing Accounting Estimates and Related Disclosures**

### **Enhanced Requirements**

- Further audit procedures must respond to the reasons for the assessed risks of material misstatement
- Determine if tests of the operating effectiveness of relevant controls will be performed
- Even if the auditor does not need control reliance an understanding of controls is necessary
- Risk assessment includes an expectation that controls are operating effectively; auditor must test controls and demonstrate operating effectiveness
- If substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level, must test controls

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## **Question for Discussion**

SAS 143 provides enhanced risk assessment requirements tailored to estimates. Which one of the following is an example of an enhanced risk assessment requirement?

- A. The auditor should consider all estimates a significant risk.
- B. The auditor should recalculate estimates to determine if they are accurate.
- C. The auditor should perform a hindsight review to evaluate the outcome of previous estimates as to the risk in the current year.
- D. Specialists should be involved in assessing the reasonableness of estimates.

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## Question for Discussion, Solution

SAS 143 provides enhanced risk assessment requirements tailored to estimates. Which one of the following is an example of an enhanced risk assessment requirement?

- A. The auditor should consider all estimates a significant risk.
- B. The auditor should recalculate estimates to determine if they are accurate.
- C. The auditor should perform a hindsight review to evaluate the outcome of previous estimates as to the risk in the current year.**
- D. Specialists should be involved in assessing the reasonableness of estimates.

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## *SAS 143, Auditing Accounting Estimates and Related Disclosures*

- If estimate deemed a significant risk, further audit procedures should include tests of controls in the current period if the auditor plans to rely on those controls
- When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details
- Concept of **reasonable** considers whether data and assumptions used in making the estimate are consistent with each other and with those used in other estimates
- Information used in constructing estimate must be appropriate
- Range or point estimate

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- In evaluating the estimate consider the possibility of management bias.  
For example:
  - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates.
  - When there has been a change from the prior period in the methods for making the accounting estimate, why, as well as the outcome of accounting estimates in prior periods.
  - Whether management's methods for making the accounting estimates, including when management has used a model, are appropriate.
  - The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions.

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- Consider the possibility of management bias (con't)
  - How management considered alternative assumptions or outcomes in making the estimate.
  - Whether the data and significant assumptions used by management in making the accounting estimates are appropriate
  - Significant difficulties encountered when obtaining evidence relating to data obtained from an external information source or valuations performed by management or management's expert.
  - Significant differences in judgments between the auditor and management or management's expert regarding valuations.

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- Consider the possibility of management bias (con't)
  - The potential effects on the entity's financial statements
  - The reasonableness of disclosures about estimation uncertainty in the financial statements
- When the auditor does not agree, will discuss reasons with management
- After explanation to management, if management does not agree to revise, this is considered a misstatement

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- Auditor must determine if disclosures are reasonable in context of financial reporting framework.
- Evaluate whether they are sufficient
- Evaluate whether they include those necessary for fair presentation even if not required by the financial reporting framework
- If high degree of estimation uncertainty, more disclosure may be needed for fair presentation

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

### **EXAMPLE**

An auditor was working on an engagement for a company that had 3 significant estimates: workers compensation claims, self-insured claims, and the allowance for doubtful accounts. The auditor noted a trend toward the low end of the range for each of these estimates in years when the company was experiencing a decrease in net income. The auditor considered whether management was biased or was intentionally misstating the reserves and allowances to show more favorable financial results.

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

- Appendix B has examples of possible discussion points with governance.
- How management identifies transactions, other events, and conditions that may give rise to the need for or changes in accounting estimates and related disclosures.
- Management's understanding (or lack thereof) regarding the nature and extent of and the risks associated with accounting estimates.
- Whether management has applied appropriate specialized skills or knowledge or engaged appropriate experts.
- The auditor's views about differences between the auditor's point estimate or range and management's point estimate.
- The auditor's views about the appropriateness of the selection of accounting policies related to accounting estimates and presentation of accounting estimates in the financial statements.

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## Question for Discussion

Which of the following is **not** true about auditing accounting estimates?

- A. The auditor must assess inherent risk separately from control risk.
- B. The auditor is required to perform a hindsight review on estimates.
- C. The auditor is required to understand the internal control around significant accounting estimates.
- D. The auditor should accept management's estimate since they are aware of important characteristics and the auditor might not be aware of them.

135



## Question for Discussion, Solution

Which of the following is **not** true about auditing accounting estimates?

- A. The auditor must assess inherent risk separately from control risk.
- B. The auditor is required to perform a hindsight review on estimates.
- C. The auditor is required to understand the internal control around significant accounting estimates.
- D. The auditor should accept management's estimate since they are aware of important characteristics and the auditor might not be aware of them.**

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## ***SAS 143, Auditing Accounting Estimates and Related Disclosures***

### **Documentation**

- Understanding of the entity and its environment, including the entity's internal control related to accounting estimates
- Linkage of further audit procedures with assessed risks
- Auditor's responses when management has not taken steps to understand and address estimation uncertainty
- Indicators of possible management bias related to estimates and the auditor's evaluation of implications
- Significant judgments relating to the auditor's determination of whether the accounting estimates and disclosures are reasonable

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## **Unit 4 Risk Assessment**

 KAPLAN



## Learning Objectives

Upon completion of this unit the participant will be able to:

- Distinguish the modifications and clarifications made to the existing Risk Assessment standard
- Implement the risk assessment standard in a financial statement audit.

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## SAS 145 –Risk Assessment

- SAS 145, *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement* issued in October 2021
- Existing AU-C 315 was amended to conform to the IAASB's revised risk assessment guidance and to address many of the deficiencies found by peer reviewers and other reviewers
- It does not fundamentally change the key concepts related to audit risk
- It clarifies and enhances certain aspects of the identification and assessment of the risks of material misstatement to drive better risk assessments
- Effective date is for years ending after December 15, 2023, to conform with SAS 143

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## SAS 145 –Risk Assessment

Standard includes six appendices that provide consideration points for understanding:

- Entity and Its Business Model
- Inherent Risk Factors
- Entity's System of Internal Control
- Entity's Internal Audit Function
- Information Technology
- General IT Controls

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## SAS 145 –Risk Assessment

- Auditing Standards Board (ASB) intends the standard to be scalable so that it addresses the needs of auditors with both complex and less complex clients.
- Standard is more principles-based and less prescriptive.
- Possibilities for scalability are integrated throughout the standard for those auditors who are dealing with less complex entities and require simpler risk assessment procedures.
- The scalability concept is based on the nature of the entity and its complexity.
- Less complex entities have less formal documentation, and the auditor may need to rely more on observation and inquiry.
- Auditor uses professional judgment to determine the nature and extent of risk assessment procedures.

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## Question for Discussion

Which of the following is true related to scalability in SAS 145?

- A. The guidance is intended for smaller accounting firms.
- B. The guidance acknowledges that audited entities are sometimes less complex and have fewer formal policies, procedures, and systems.
- C. The guidance is intended to be used on smaller audit clients. Typically, they have less than \$1,000,000 in revenue.
- D. The guidance is useful for less complicated entities that use special purpose frameworks such as the modified cash basis of accounting.

143



## Question for Discussion, Solution

Which of the following is true related to scalability in SAS 145?

- A. The guidance is intended for smaller accounting firms.
- B. The guidance acknowledges that audited entities are sometimes less complex and have fewer formal policies, procedures, and systems.**
- C. The guidance is intended to be used on smaller audit clients. Typically, they have less than \$1,000,000 in revenue.
- D. The guidance is useful for less complicated entities that use special purpose frameworks such as the modified cash basis of accounting.

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## SAS 145 –Risk Assessment

- Interrelated definitions
  - **Significant account balances** – Respondents to the risk assessment exposure draft were confused about when auditors would be required to assess risk. The first important definition to understand is **significant**. An account balance, class of transactions, or disclosure is significant when there is one or more **relevant assertions** associated with it. The determination of significance is based on **inherent risk**, which is assessed without regard to internal controls. Note that the term significant is not synonymous with material. **And not all significant account balances will be significant risks.**
  - **Significant risk** – A significant risk is a risk that is at the high end of the spectrum of inherent risk.

145



## SAS 145 –Risk Assessment

- Interrelated definitions
  - **Relevant assertion** – The term **relevant assertion** was unclear. A relevant assertion is one that has an identified risk of material misstatement. To determine if an assertion has an identified risk of material misstatement the auditor would evaluate it to determine if a risk of material misstatement is present. Evaluate:
    - Likelihood – there is a reasonable possibility that the misstatement could occur
    - Magnitude – there is a reasonable possibility that the risk is material.

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## SAS 145 –Risk Assessment

- Interrelated definitions
  - **Reasonably possible** – The term **reasonably possible** needs to be defined so that it is not misinterpreted. As in other professional literature the term reasonable possibility is **less than probable** (also defined as likely) but **more than remote**. A risk of material misstatement may relate to more than one assertion. In that case all the assertions related to the risk are relevant assertions.
  - The identification of risks of material misstatement is performed on the basis of inherent risk and is the auditor's preliminary consideration of misstatements that have a reasonable possibility of occurring and being material if they were to occur.

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## SAS 145 –Risk Assessment, Example – Property

Assertion	Likelihood	Magnitude
Existence	Most of the entity's property is not susceptible to theft and the property that is susceptible (like laptop computers in the classroom) is not material. The entity does not purchase much property. <b>Assessment:</b> Not reasonably possible	Assessment: Not reasonably possible that the balance would be materially misstated. Not a relevant assertion.
Completeness	<b>Likelihood</b> that the asset listing is not complete- when property is purchased it is rarely financed. The entity does not purchase much property from year to year. Large capital items are discussed at length and approved by the board. <b>Assessment:</b> Not reasonably possible	<b>Assessment:</b> not reasonably possible that the balance could be materially misstated. Not a relevant assertion.

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## SAS 145 –Risk Assessment, Example – Property

Assertion	Likelihood	Magnitude
Valuation	<p><b>Likelihood</b> that the assets could be impaired. The property is recorded at historical cost and has been on the books for decades. It would not be a reasonable possibility that there could be sufficient decline in property values to cause an impairment issue. The entity is very profitable.</p> <p><b>Assessment: Not reasonably possible</b></p>	<p><b>Assessment:</b> not reasonably possible that the balance could be materially misstated. Not a relevant assertion.</p>
Rights and obligations	<p><b>Likelihood</b> that the assets or debt reflected on the books are not those of the entity. This is an established entity with very few property transactions.</p> <p><b>Assessment: Not reasonably possible</b></p>	<p><b>Assessment:</b> not reasonably possible that the balance could be materially misstated. Not a relevant assertion.</p>

149

## SAS 145 –Risk Assessment, Example – Property

Assertion	Likelihood	Magnitude
Rights and obligations	<p><b>Likelihood</b> that the assets or debt reflected on the books are not those of the entity. This is an established entity with very few property transactions.</p> <p><b>Assessment: Not reasonably possible</b></p>	<p><b>Assessment:</b> not reasonably possible that the balance could be materially misstated. Not a relevant assertion.</p>
Cutoff	<p><b>Likelihood</b> that the depreciation is not recorded in the proper period. This is a routine entry.</p> <p><b>Likelihood</b> that gains or losses would not be properly recorded in the proper period. The entity is unlikely to have this situation since that it uses the assets for more than the useful lives recorded.</p> <p><b>Assessment: Not reasonably possible</b></p>	<p><b>Assessment:</b> not reasonably possible that the balance would be materially misstated. Not a relevant assertion.</p>

150

## SAS 145 –Risk Assessment, Example – Property

Assertion	Likelihood	Magnitude
Accuracy	Very few purchases or write offs. Depreciation is a routine entry. <b>Assessment: Not reasonably possible</b>	<b>Assessment:</b> not reasonably possible that the balance would be materially misstated. Not a relevant assertion.
Classification	Very few purchases occur. Repairs and maintenance is more likely to be misclassified. <b>Assessment: Not reasonably possible</b>	<b>Assessment:</b> not reasonably possible that the balance would be materially misstated. Not a relevant assertion.
Presentation and Disclosure	Presentation and disclosure of property is not complex. <b>Assessment: Not reasonably possible</b>	<b>Assessment:</b> not reasonably possible that the disclosures would be materially misleading, omitted or misstated. Not a relevant assertion.

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## SAS 145 –Risk Assessment, Example – Receivables

Assertion	Likelihood	Magnitude
Existence	The risk would be that the accounts payable included on the detail did not exist. The possibility was evaluated as remote for existence since the transactions that go through accounts payable are routinely processed. <b>Assessment: Not reasonably possible</b>	<b>Assessment:</b> Not reasonably possible that the balance could be materially misstated.
Completeness	<b>Likelihood</b> that the AP listing may be missing some items. <b>Assessment: Reasonably possible</b>	<b>Assessment:</b> Reasonably possible that the balance could be materially misstated. Relevant assertion
Valuation	<b>Likelihood</b> that the assets could be impaired. The property is recorded at historical cost and has been on the books for decades. It would not be a reasonable possibility that there could be sufficient decline in property values to cause an impairment issue. The entity is very profitable. <b>Assessment: Not reasonably possible</b>	<b>Assessment:</b> not reasonably possible that the balance would be materially misstated. Not a relevant assertion.

152

## SAS 145 –Risk Assessment, Example – Receivables

Assertion	Likelihood	Magnitude
Rights and obligations	<p><b>Likelihood</b> that the assets or debt reflected on the books are not those of the entity. This is an established entity with very few property transactions.</p> <p><b>Assessment: Not reasonably possible</b></p>	<p><b>Assessment:</b> not reasonably possible that the balance could be materially misstated. Not a relevant assertion.</p>
Cutoff	<p><b>Likelihood</b> that the AP listing may be contain items that should have been recorded in a different period.</p> <p><b>Assessment: Reasonably possible</b></p>	<p><b>Assessment:</b> Reasonably possible that the balance could be materially misstated. Relevant assertion.</p>
Accuracy	<p>With the volume of activity running through accounts payable it is reasonably possible that invoice information could be misposted.</p> <p><b>Assessment: Reasonably possible</b></p>	<p><b>Assessment:</b> remote possibility that the balance would be materially misstated. Not a relevant assertion.</p>

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## SAS 145 –Risk Assessment, Example – Receivables

Assertion	Likelihood	Magnitude
Classification	<p>Remote possibility that an item that should be included in accounts payable would be included in a different account balance or classified as noncurrent when it should be current. If the amounts were posted as accrued liabilities this would not make a difference.</p> <p><b>Assessment: Not reasonably possible</b></p>	<p><b>Assessment:</b> not reasonably possible that the balance could be materially misstated. Not a relevant assertion.</p>
Presentation and Disclosure	<p>Presentation and disclosure of accounts payable is not complex.</p> <p><b>Assessment: Not reasonably possible</b></p>	<p><b>Assessment:</b> not reasonably possible that the disclosures would be materially misleading, omitted or misstated.</p>

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## SAS 145 –Risk Assessment

### Risks at the Financial Statement Level

- Risk is broad and pervasive, potentially affecting several account balances, classes of transactions and assertions.
- Auditor attempts to take the risk down to the account balance and assertion level but that is not always possible.
- The auditor is **no longer** required to assess whether overall financial statement risks are significant risks.

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## SAS 145 –Risk Assessment

### Risks at the Account Balance/ Assertion Level

- Risk relates to relevant assertions where specific preventive and detective control activities are able to minimize the risk.

SAS 145 requires the auditor to assess the risk of **significant** account balances, classes of transactions or disclosures and only for relevant assertions within those account balances and classes of transactions.

- Definition of significant account balances is now one with a relevant assertion.
- When assessing the risk of material misstatement, the auditor is aware that both the risk of error and the risk of fraud should be assessed.

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## SAS 145 –Risk Assessment

### Understand aspects of the entity and its environment

- Entity's organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT
- Industry, regulatory, and other external factors
- Measures used, internally and externally, to assess the entity's financial performance
- Applicable financial reporting framework and the entity's accounting policies and the reasons for any changes.
- How inherent risk factors affect the susceptibility of assertions to misstatement in the preparation of the financial statements in accordance with the applicable financial reporting framework, and the degree to which affect it
- Whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework.

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## SAS 145 –Risk Assessment

### Clarification and Emphasis Points

- Enhances and emphasizes the auditor's professional skepticism
- Highlights the benefits of maintaining professional skepticism during the required engagement team discussion
- Stresses that contradictory evidence may be obtained as part of the auditor's risk assessment procedures.
- Modernizes the standard for an evolving business environment.
- Technological and the increasingly complex nature of, the economic and regulatory aspects of the markets that entities operate in today.

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## SAS 145 –Risk Assessment

- Considers the entity and the auditor’s ability to use automated tools and techniques when performing risk assessment procedures.
- Highlights the importance of understanding the entity’s financial reporting system and financial reporting framework.
- Auditor should understand how inherent risk factors affect susceptibility of assertions to misstatement in the preparation of the financial statements in accordance with the applicable financial reporting framework

As a part of understanding the financial reporting system, the standard provides an **explicit** requirement to understand the use of IT in the entity’s structure, ownership, governance, and business model. This involves understanding the IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes.

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## SAS 145 –Risk Assessment

### Analytical Procedures

- Auditor performs analytical procedures as risk assessment procedures to help identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends
- When unusual or unexpected relationships are identified this may mean that there is a risk of material misstatement due to error or fraud
- When analytical procedures are performed as risk assessment procedures they are typically performed at a high level on aggregated data.
- The auditor also performs final analytical procedures near the end of the audit and may perform substantive analytical procedures during the audit.

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## SAS 145 –Risk Assessment

### Analytical Procedures

- AU-C 520 requires the auditor to look for inconsistencies near the end of the audit as part of the conclusion about the financial statement presentation.
- AU-C 520 requires the auditor to set an expectation of plausible relationships that are reasonably expected to exist and evaluate the results of the test against the actual account balance/class of transaction for substantive analytical procedures.
  - The auditor is required to follow up on amounts differences that exceed a certain threshold set by the auditor. Disaggregation of data enables a more precise expectation.

**NEW!!** Preliminary analytical procedures are addressed in AU-C 315 which does not require the auditor to set an expectation although the application guidance states that it is helpful.

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## SAS 145 –Risk Assessment

### Journal Entries

- The level of work to be performed in understanding and testing journal entries was also clarified.
- SAS 145 does not require the auditor to understand the process and controls over **all** journal entries and other adjustments.
- Auditor should understand the process surrounding the financial statement closing process including **examining** material journal entries and other adjustments.
- Auditor should also understand controls over journal entries related to significant risks, when testing operating effectiveness and others the auditor feels is appropriate.

**EMPHASIS!!** SAS 145 emphasizes the importance of professional skepticism and highlights the benefits. As also discussed in SAS 144, *Audit Evidence* the standard also highlights that it is important to be alert for contradictory evidence as well as corroborative evidence when performing a risk assessment

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## SAS 145 –Risk Assessment

### Understanding Internal Control

- Results of peer reviews identified deficiencies in audits due to a lack of understanding of the terminology and procedures needed to understand an entity's internal control.
- Many auditors do not fully understand:
  - why the assessment of internal control is so important in planning the audit
  - which procedures were required when obtaining the understanding
  - whether it was important to understand all components of internal control

SAS 145 clarifies which aspects of the entity's system of internal control are integral to the risk assessment process and the level of work that is necessary in obtaining the required understanding.

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## SAS 145 –Risk Assessment

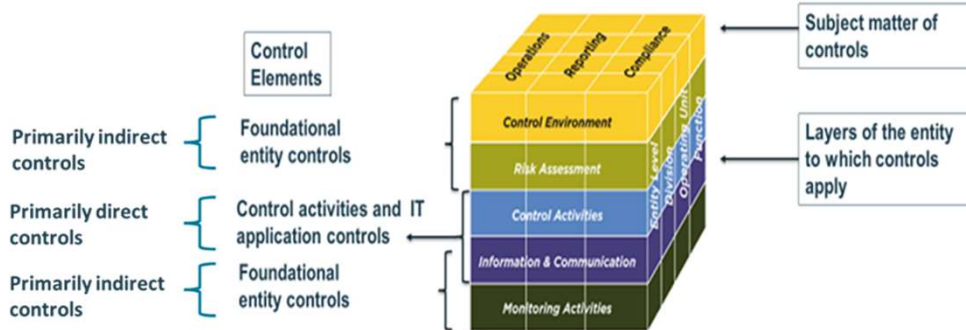
SAS 145 modifies two definitions that the AICPA believes will help auditors to understand the rationale behind understanding internal control

- **Internal controls** – This term has been changed to **system of internal control**. The definition was updated to illustrate that it reflects five interrelated components, all of which are important to the auditor's understanding of the system of internal control
- **Controls** – Policies or procedures that are embedded within the components of the system of internal control to achieve the control objectives of management or those charged with governance.

**EMPHASIS!** The requirements for understanding internal control in SAS 145 are more specific in that the level of understanding required for each of the 5 components of internal control is prescribed by the standard. The standard directly states that the overall requirements for understanding the entity's system of internal control should address **each** of the components.

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## SAS 145 –Risk Assessment



Auditor obtains an understanding of each of the 5 levels of internal control.

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## SAS 145 –Risk Assessment

Level of Internal Control	Understanding Required- SAS 145
Control Environment	<p>The auditor should obtain an understanding of the control environment relevant to the preparation of the financial statements. In this the auditor will understand:</p> <ul style="list-style-type: none"> <li>Controls, processes, and structures that address how management’s oversight responsibilities are carried out. This includes the entity’s culture and management’s commitment to integrity and ethical values.</li> <li>The oversight of the entity’s system of internal control by, those charged with governance when those charged with governance are separate from management</li> <li>Entity’s assignment of authority and responsibility</li> <li>How the entity attracts, develops, and retains competent individuals</li> <li>How the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control</li> <li>Deficiencies in the control environment undermine the other components of the entity’s system of internal control.</li> </ul>

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## SAS 145 –Risk Assessment

Level of Internal Control	Understanding Required- SAS 145
Risk Assessment	<p>The auditor should obtain an understanding of the entity's risk assessment process relevant to the preparation of the financial statements by understanding the entity's process for:</p> <ul style="list-style-type: none"><li>▪ identifying business risks, including the potential for fraud, relevant to financial reporting objectives</li><li>▪ assessing the significance of those risks, including the likelihood of their occurrence</li></ul> <p>Based on the auditor's understanding of whether the entity's risk assessment is appropriate to the size and complexity of the entity the auditor should evaluate whether there are control deficiencies present.</p> <p>If the auditor identifies risks of material misstatement that management failed to identify, the auditor should determine how the risk assessment process failed if the auditor believes that the entity's risk assessment process should have detected the risk.</p>

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## SAS 145 –Risk Assessment

Level of Internal Control	Understanding Required- SAS 145
Monitoring	<p>The auditor should obtain an understanding of the entity's process for monitoring the system of internal control relevant to the preparation of the financial statements</p> <p>This could include ongoing as well as separate evaluations for monitoring the effectiveness of controls, identification of deficiencies and implementing corrective action.</p> <p>Should the entity have an internal audit function, the auditor will understand its nature, responsibilities and activities.</p> <p>In obtaining the understanding the auditor will want to identify the sources of information used in the entity's monitoring process and how management evaluates the reliability of the information they use.</p> <p>The auditor will then evaluate whether the entity's process for monitoring the system of internal control is appropriate to the entity's circumstances considering the nature and complexity of the entity.</p>

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## SAS 145 –Risk Assessment

Level of Internal Control	Understanding Required- SAS 145
Information and Communication	<p>Evaluate aspects of the information and communication components</p> <p>Understanding specifically includes- flows of transactions and other aspects of the entity’s information processing activities for significant classes of transactions, account balances and disclosures</p> <p>Includes communication of significant matters</p> <p>Does not require the auditor to evaluate the design or determine implementation of individual controls in this component</p> <p>The individual identification of controls is focused on information processing controls referred to as transaction controls.</p>

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## SAS 145 –Risk Assessment

### More Robust Understanding of IT

- IT system may include manual as well as automated elements.
- The auditor is required to identify IT applications and other aspects of the IT environment that are based on the **identified** controls
- Auditor gathers information about the nature and characteristics of the IT applications used and information about the supporting IT infrastructure.
- Include understanding the complexity or level of customization related to IT applications, third-party hosting or outsourcing, and use of interfaces, data warehouses, or report writers.
- Emerging technology may indicate risk.
- General IT controls do not need to be identified for every IT process.
- Important to obtain an understanding of those that are mitigate the risks of material misstatement.

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## SAS 145 –Risk Assessment

- **EMPHASIS!!** The understanding of the entity's IT and flow of transactions is important here because of the change in the requirements for understanding control activities.
- Auditor is required to evaluate the design and implementation of control activities over a limited number of areas.
- Pre SAS 145 the auditor would understand the design of controls and whether they were implemented over the significant systems which were viewed to be those that process a material dollar value of transactions
- Now the auditor is not required to go to that level of detail except for specific areas
- This makes understanding of the flow of transactions and other aspects of the entity's information processing activities for significant classes of transactions, account balances and disclosures even more important.

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## SAS 145 –Risk Assessment

<b>Less likely to give rise to IT Risk</b>	<b>More likely to give rise to IT Risk</b>
<ul style="list-style-type: none"><li>▪ Stand alone applications</li><li>▪ Volume of data is not significant</li><li>▪ Application's functionality is not complex</li><li>▪ Each transaction is supported by hard copy documentation</li><li>▪ Management does not rely on automated controls</li><li>▪ Management does not rely on the system to produce complete and accurate reports- manual reconciliations are performed</li><li>▪ Auditor intends to directly test information produced by the entity as audited evidence</li></ul>	<ul style="list-style-type: none"><li>▪ Applications are interfaced</li><li>▪ Volume of transactions is significant</li><li>▪ Functionality is complex because of automatic initiation and processing of transactions</li><li>▪ Complex calculations are made by IT</li><li>▪ Management relies on the application to perform automated controls</li></ul>

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## SAS 145 –Risk Assessment

- The SAS is very specific in what the auditor is required to understand **(Identified Controls)**
- Auditor is **required to** evaluate the design and implementation of controls over the following:
  - Controls that address a risk that is determined to be a significant risk
  - Controls over journal entries and other adjustments
  - Controls for which the auditor plans to test operating effectiveness
  - Controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence
  - Other controls that, based on the auditor’s professional judgment, the auditor considers are appropriate

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## SAS 145 –Risk Assessment

- Auditor is only required to understand internal control for account balances, classes of transactions, and disclosures that are significant risks
- Eliminates the volume-based method used primarily by auditors today
- Auditor uses judgment to assess risks related to those assertions that have a reasonable possibility of occurring and reasonable possibility of being material.
- From those the auditor evaluates whether the risk is a significant risk (higher on the spectrum of inherent risk)
- Materiality and audit risk are considered when identifying and assessing the risk of material misstatement
- Auditor’s determination of materiality is a matter of professional judgment and affected by their perception of the needs of users of the financial statements

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## SAS 145 –Risk Assessment

- Classes of transactions, account balances, or disclosures are material if there is a substantial likelihood that omitting, misstating, or obscuring information about them would influence the judgment made by a reasonable user based on the financial statements
- Therefore, the auditor should consider materiality in that context when evaluating relevant assertions
- Not all risks associated with material account balances and classes of transactions will be considered significant risks.
- Auditor may determine that these areas fall into the “other control” category and obtain an understanding over them
- Lack of segregation of duties

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## SAS 145 –Risk Assessment

- Auditor evaluates design of the identified control
- Auditor determines whether the identified control has been implemented by determining that the control exists, and that the entity is using it.
  - Inquiry of entity personnel
  - observing the performance of specific controls
  - inspecting documents and reports
  - reperforming the specific controls.

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## SAS 145 –Risk Assessment

- **Walk-through** involves following a transaction from origination through the entity's processes, including information systems, until it is reflected in the entity's financial records, using the same documents and IT that entity personnel use.
- A walk-through is usually sufficient to evaluate design and determine implementation.
- **Inquiry** is an important part of performing a walk-through
- Inquiry alone is not sufficient to determine whether a control has been implemented.
- Control risk cannot be less than high unless controls are tested

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## SAS 145 –Risk Assessment

- **Team discussion**
- Engagement team members can exchange information
  - business risks
  - how inherent risk factors may affect the susceptibility of classes of transactions, account balances, and disclosures to misstatement
  - how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- AU-C 240 requires the engagement team discussion to place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud
- Team members benefit because they can communicate and share information
- The risk assessment is generally a byproduct of this discussion.

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## SAS 145 –Risk Assessment

- **Inherent risk factors** – characteristics that affect susceptibility to misstatement of an assertion about a class of transactions, account balance, or disclosure
- Auditor uses the inherent risk factors to evaluate certain aspects of events or conditions that affect an assertion's susceptibility to misstatement
  - Complexity
  - Subjectivity
  - Change
  - Uncertainty
  - Susceptibility to fraud
- **Spectrum of inherent risk.** Inherent risk factors individually or in combination affect inherent risk to varying degrees and that inherent risk will be higher for some assertions than for others.

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## SAS 145 –Risk Assessment

### Significant Risk

- Auditor will classify the inherent risk as high, moderate, or low. Then the auditor will determine if the risk is a significant risk.
- A significant risk is defined as a risk of material misstatement where the assessment of inherent risk is close to the upper end of the spectrum of inherent risk
- There are also risks that are required to be treated as significant risks in accordance with an AU-C section such as the risk of fraud and significant unusual transactions with related parties.

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## SAS 145 –Risk Assessment



### 1. Account balance and assertion: Prepaid expenses, accuracy

Issue identified in planning: Client has little regard for this account and does not adjust it from period to period. Unless there is a change in the circumstances of the entity although it is reasonably possible the balance will be misstated, it is remote that the amount could be material. No significant changes were noted during the current year. **Determination: No relevant assertions. Assessment of risk is not required.**

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## SAS 145 –Risk Assessment



### 2. Account balance and assertion: Accounts receivable, valuation

Accounts receivable balance is material to the financial statements. During the year, the pandemic caused the aging to deteriorate. In addition, the client is implementing the current expected credit loss standard.

The client believes that each year 5% of revenue should be reserved as an allowance. In prior audits, adjustments have been made because the client's customers have more risk than the industry average. Due to the change in accounting principles, the allowance for bad debts should anticipate the amount of credit risk for all receivables, even those that are current. Since the client uses a generic formula to compute bad debt expense and the allowance and there is more uncertainty due to the economy and the new accounting principle, it is reasonably possible that the balance will be misstated and the amount material. **Determination: Significant Risk**

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## SAS 145 –Risk Assessment



### 3. Warranty Reserve

During the year the client had issues with some of its products and began to see a high level of warranty claims. It is reasonably possible that these claims will occur in amounts previously unanticipated and the amount will be material. Since there is little historical evidence to assist management in developing the estimate there is a higher risk of uncertainty.

**Determination: Significant Risk**

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## SAS 145 –Risk Assessment

- AU-C 330 states that the auditor is not required to perform substantive procedures for account balances/classes of transactions that are not significant
- Auditor will generally perform limited procedures which may consist of tying out balances to details or making a computation to adjust the balance so that it is appropriate.
- This is a change to AU-C 330 where previously if the account balances were material procedures were performed.

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## Question for Discussion

There are 2 different categories of risk noted in the standard. They are \_\_\_\_\_ risks and \_\_\_\_\_ risks.

- A. Direct and indirect.
- B. Significant and fraud.
- C. Overall financial statement and assertion level.
- D. Audit and credit.

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## Question for Discussion, Solution

There are 2 different categories of risk noted in the standard. They are \_\_\_\_\_ risks and \_\_\_\_\_ risks.

- A. Direct and indirect.
- B. Significant and fraud.
- C. Overall financial statement and assertion level.**
- D. Audit and credit.

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## SAS 145 –Risk Assessment

- The auditor’s assessment of risk should be revisited any time there are developments during the audit that affect it
- Should the auditor’s identify issues that affect the risk assessment, they should go back and modify it.
- **Stand-back requirement** designed to provide the auditor with an additional opportunity to evaluate the completeness of the identification of significant account balances, classes of transactions, and disclosures
- These are places where up to this point the auditor has not identified any risks of material misstatement that are reasonably possible and has not identified relevant assertions

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## SAS 145 –Risk Assessment

### New documentation requirements

- There are two new documentation requirements in addition to those in the existing standard.
  - Documentation of the evaluation of the design of identified controls and determination of whether such controls have been implemented.
  - The rationale for significant judgments made regarding the identified and assessed risks of material misstatement. This means the rationale for the assessment of inherent risk.

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## SAS 149 –Special Considerations—Audits of Group Financial Statements

- SAS No. 149 introduces the concept of a "referred-to auditor."
  - This refers to an auditor performing an audit on a component's financial statements that the group engagement partner decides to reference in their report on the group financial statements.
  - Importantly, referred-to auditors are distinct from component auditors. They are not part of the group engagement team, unlike component auditors whose work is directly overseen by the group engagement partner.

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## SAS 149 –Special Considerations—Audits of Group Financial Statements

- The definition of "component auditor" has also been revised to emphasize their role within the engagement team.
- This change reinforces the group engagement partner's responsibility for directing, supervising, and reviewing the work of component auditors, ultimately enhancing audit quality.
  - Equity method investments remain considered components under SAS No. 149.
  - The standard outlines specific procedures for the group auditor to assess the use of the equity method investment's audited financial statements and audit report as audit evidence.
  - Additionally, it identifies situations where further procedures might be necessary and provides options for the group auditor to obtain sufficient and appropriate audit evidence.

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# Unit 5 Engagement Quality



## Learning Objectives

Upon completion of this unit the participant will be able to:

- Distinguish the important qualities of an engagement team, especially the audit partner, that contribute to quality in an audit engagement
- Recognize how the quality at the engagement level fits into the firm's overall responsibility for quality for the work it performs.





## SAS 146, Engagement Quality Management

- Standard applies only to audit engagements
- Reiterates relationship between the partner and the EQ reviewer.
- Engagement partner is ultimately responsible for the conduct of the engagement.
- The engagement team, led by the partner, is responsible for
  - implementing the firm's policies related to engagement quality
  - determining whether to design and implement responses at the engagement level over and above those in the firm's policies
  - communicating information about audit engagement that is required by the firm's policies or in support of the firm's quality management system.

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## SAS 146, Engagement Quality Management

- Engagement partner may assign certain tasks to others within the engagement team.
- Partner should be appropriately involved throughout the engagement
- Partner working alone – some requirements can't be followed
- The phrase “take responsibility for...” – the engagement partner is permitted to assign the certain activities to experienced team members.
- Requirements specify that the engagement partner **should** do something – the engagement partner is required to conduct that activity.
- Team members may provide information to the partner, but the task remains with the partner.

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## SAS 146, Engagement Quality Management

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## SAS 146, Engagement Quality Management

### EXAMPLE

- An engagement team consisted of a partner, an experienced manager and two staff members. The partner assigned the primary review of work to the manager along with the day-to-day monitoring of the engagement's progress. The manager prepared an analysis of matters for the attention of the partner for the partner to use in completing the required reviews. The partner reviewed the planning and risk assessment conclusions made by the team along with areas where risk was assessed as significant, the final analytics, the financial statements and independent auditor's report and other communications to those charged with governance. In this way, the partner was able to leverage the skills of the experienced manager, provide support and training to that person and fulfill the firm's policies related to audit quality as well as the relevant professional requirements.

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## SAS 146, Engagement Quality Management

- **Fulfilling leadership responsibilities** – environment for the engagement emphasizes the firm's culture and the expected behavior of engagement team members
- **Understand the relevant ethical requirements** – independence and other ethical requirements. Ensure team members are aware of ethical requirements including the firm's related policies.
- **Partner** should identify, evaluate and address:
  - Threats to compliance with relevant ethical requirements, including independence
  - Circumstances that may cause a breach of relevant ethical requirements
  - Responsibilities of members of the engagement team when they become aware of an instance of noncompliance with laws and regulations by the entity

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## SAS 146, Engagement Quality Management

- **Partner** should determine whether ethical requirements, including those related to independence, have been fulfilled before dating the report
- **Acceptance and continuance of client relationships.** The partner should determine that firm policies and procedures have been followed and appropriate conclusions have been reached and documented.
- If the team becomes aware of information that could have caused a different decision, communicate to the firm.
- **Engagement Resources.** The partner should ensure that:
  - the engagement is appropriately staffed
  - people on the engagement collectively have the knowledge, competence and capabilities and time to perform the engagement.

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## SAS 146, Engagement Quality Management

- **Supporting engagement performance – partner** takes responsibility for the nature, timing, and extent of the direction, supervision, and review of the work performed.
- The partner should review the audit documentation at appropriate points in time during the audit engagement related to:
  - significant matters
  - significant judgments, including on difficult or contentious matters and the conclusions reached
  - other matters that, in the engagement partner’s professional judgment, are relevant to the engagement partner’s responsibilities.

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## SAS 146, Engagement Quality Management

### **Supporting engagement performance.**

- If contentious issues arise, the partner is responsible for handling the consultation and implementing any resolution.
- Also true for any disagreements among the engagement team members.
- On or before the date of the auditor’s report, the **partner** should determine that sufficient appropriate audit evidence has been obtained to support the conclusions reached

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## SAS 146, Engagement Quality Management

### Supporting engagement performance.

- When an engagement quality review is required the engagement partner should:
  - determine that an engagement quality reviewer has been appointed.
  - cooperate with the engagement quality reviewer and ensure the cooperation of other members of the engagement team
  - discuss significant matters and significant judgments arising during the audit engagement, including those identified during the engagement quality review, with the engagement quality reviewer
  - release the auditor's report **only** after the completion of the engagement quality review.

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## SAS 146, Engagement Quality Management

### Monitoring and Remediation

- **Partner** should take responsibility for understanding the information provided by the firm's monitoring process and determine the effect on the engagement. Take action to remediate if necessary.

### Taking Overall Responsibility for Managing and Achieving Quality

- SAS 146 contains a "stand-back" requirement.
- This should occur before dating the report.

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## SAS 146, Engagement Quality Management

### Documentation

- Significant issues identified, discussions with team and conclusions reached relating to ethical requirements, including independence
- Acceptance/continuance of the client relationship and audit engagement
- Nature and scope of, and conclusions resulting from, consultations during the audit and how the conclusions were implemented
- If the engagement is subject to an EQR, that the review has been completed before the release of the auditor's report
- Documentation required by other professional standards

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## Reminders

- **Post event evaluation:** Please complete the course evaluation that will be viewable once the session ends. We welcome your feedback!

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**KAPLAN**