Kaplan's Guide to Recently Issued Auditing Standards

(RIAS4)

KAPLAN

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KAPLAN'S GUIDE TO RECENTLY ISSUED AUDITING STANDARDS (RIAS4)
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NOTES

Introduction

The Auditing Standards Board (ASB) issued a significant number of new auditing standards from 2019–2023. This represents a major update to audit literature since the implementation of the risk assessment standards in 2006 through 2008. There were several reasons for this activity, most notably the desire to conform with international standards. Over the past 20 years, it has become increasingly evident that we live in a global marketplace for goods and services. Geographic boundaries make little difference when it comes to commerce, information flow, and access to capital. Companies have become more and more global; some are headquartered in the United States with foreign subsidiaries, others are headquartered overseas and have U.S. subsidiaries. This is even true, although to a lesser extent, with not-for-profits.

The digital age has revolutionized the way businesses operate, fostering a truly globalized marketplace. Technology advancements that seemed unimaginable in 2000 are now commonplace, and even small businesses and nonprofits are adopting software that significantly reduces paper trails. Audit firms are also leveraging technology to automate certain steps in financial statement audits.

Recognizing these trends, the ASB implemented a formal international strategy. This strategy prioritizes the convergence of the American Institute of Certified Public Accountants (AICPA) standards with International Standards on Auditing (ISA). Additionally, the ASB aims to minimize discrepancies with the Public Company Accounting Oversight Board (PCAOB) standards. While complete convergence with international or PCAOB standards may not be achievable due to the varying needs of companies served by these organizations, this initiative, combined with the need to address emerging technologies, has led to a significant number of new ASB standards issued in recent years.

The ASB also seized the opportunity to clarify areas that have historically caused difficulties for peer reviewers. Ambiguous terminology in prior standards often led to confusion and deficiencies in peer reviews. These new standards aim to rectify these issues.

Recently issued standards are:

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*

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)*

After a refresher on SAS 134-140 this program focuses on the standards effective for calendar year end audits 2022 through 2026 (SAS 142-149).

UNIT 1

Auditor Reporting

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- 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.

RECENTLY ISSUED REPORTING STANDARDS

Four of the newly issued standards impact the independent auditor's report. The 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.

SAS 139 makes conforming changes to the AU-C sections dealing with special purpose frameworks (AU-C 800), single purpose financial statements and specific elements, accounts, or items of financial statements (AU-C 805), and summary financial statements (AU-C 810). Auditors will want to consult the standard for the appropriate wording changes. SAS 139 will not be discussed further in this manual.

SAS 140 makes conforming changes to AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, AU-C 730, *Required Supplementary Information* and AU-C 930, *Interim Financial Information.* It also amends the AU-C sections dealing with supplementary information (AU-C 725) and required supplementary information (AU-C 730) to report this information in a separate section of the auditor's report as opposed to in an other-matter paragraph. 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. SAS 140 will not be discussed further in this manual.

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. This 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 that were set forth only in the AICPA's Accounting & Audit Guide on Employee Benefit Plans. Accordingly, a new AU-C section 703 was created. AU-C 703 a supplement to the other AU-C sections. Accordingly, it is not all inclusive of the procedures to be performed in an ERISA audit.

In addition to report wording to conform to that in SAS 134, perhaps the most significant change to the employee benefit plan audit is to what was referred to as the "limited scope" audit. Management may still elect to have this type of audit if certain requirements are met. However, the 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. In this type of audit, the auditor no longer issues a disclaimer of opinion but issues two opinions that

- The 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.
- The 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 reports that are used in full scope audits as well as Section 103(a)(3)(C) audits. SAS 136 will not be discussed further in this manual.

Nature of SAS and AU-C Sections

The ASB issues SASs primarily to cover a certain subject matter or to make amendments to several standards. Once effective the content in a SAS folds into the various AU-C sections where a body of information on a specific subject is covered. Often, the SAS will focus on one specific element such as reporting. However, since it may cover other subject matter as a secondary focus, it is helpful for auditors to understand the AU-Cs affected by the SAS.

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 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
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

Auditor Reporting and Amendments in SAS 134

The new auditor reporting standards make significant changes to the reporting model. Much of the information previously communicated in the report is the same. However, there are some important changes such as:

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.

AU-C 700 contains several illustrations of the unmodified auditor's report. The report presented below is comparative. Other report form illustrations in the standard are:

- Auditor's Report on Comparative Financial Statements Prepared in Accordance with GAAP
- Auditor's Report on Comparative Financial Statements Prepared in Accordance with GAAP Including Communication of Key Audit Matters

- Auditor's Report on Financial Statements for a Single Year Prepared in Accordance with GAAP
- Auditor's Report on Comparative Financial Statements Prepared in Accordance with GAAP when the Audit Has Been Conducted in Accordance with Both GAAP and International Standards on Auditing
- Auditor's Report on Financial Statements for a Single Year Prepared in Accordance with GAAP when Comparative Summarized Financial Information Derived from Audited Financial Statements for the Prior Year Is Presented
- Auditor's Report on Financial Statements for a Single Year Prepared in Accordance with GAAP when Comparative Summarized Financial Information Derived from **Unaudited** Financial Statements for the Prior Year Is Presented
- Auditor's Report on Comparative Financial Statements Prepared in Accordance GAAP when the Audit Has Been Conducted by a Registered Firm in Accordance with Both GAAP and the Auditing and Professional Practice Standards of the PCAOB
- Auditor's Report on Comparative Financial Statements Prepared in Accordance with GAAP when the Audit Has Been Conducted by a Nonregistered Firm in Accordance with Both GAAP and the Auditing Standards of the PCAOB

The majority of reports will begin with the opinion. However, if the auditor also issues a report on other legal and regulatory requirements then the auditor's report begins with "Report on the Audit of the Financial Statements" to distinguish the two. The standard comparative unmodified auditor's report is illustrated in the example below.

EXAMPLE

Independent auditor's report

Opinion

We have audited the financial statements of, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in Joe's Adventure Company's 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.

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 1 year.

Auditor's Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Joe's Adventure Company's internal control. Accordingly, no such opinion is expressed. (See note 1 below.)
- 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

Note 1: The auditor generally does not express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements. However, in circumstances where the auditor also has a responsibility to express such an opinion the following phrases would be omitted, "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."

Note 2: If there is a Report on Legal and Regulatory Requirements, a paragraph cross referencing to that report should be added as the last paragraph. The Report on Internal Control and Compliance that is required under Government Auditing Standards is an example of such a requirement.

AU-C 705 (Report Modifications) and AU-C 706 (Emphasis and Other Matter paragraphs) and Key Audit Matters

AU-C 705 contains the modifications to the auditor's report. The standard provides examples for 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 appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

The auditor includes an other-matter paragraph when required by GAAS, or at the auditor's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

These definitions are not new. AU-C 706 does not state the order in which these paragraphs should be placed in the auditor's report if there is more than one matter, but notes that the placement really depends on the information to be communicated and the auditor's judgment related to its significance.

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. The auditor would decide about the relative significance of the information based on the auditor's judgment about the relative significance of the information included in the emphasis-of-matter paragraph.

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.

Key Audit Matters—The auditor may be engaged by management to report on key audit matters. AU-C 701 is a new codification section written in response to the ASB's decision to require Key Audit Matters (KAMs) to be discussed in the report if the auditor is engaged report on them. The IIASB and the PCAOB require the reporting of Critical Audit Matters (CAMs).

KAMs are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. The types of issues that should be considered as possible KAMs are:

- 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

Since SAS 134 was just effective for calendar year 2021 audits it is too soon to definitively say whether many auditors will be reporting on KAMs. Anecdotally, it appears unlikely due to the size of many of the companies and not-for-profits that required financial statement audits.

The section on KAMs is 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. These matters may only be communicated when the auditor forms an opinion on the financial statements. If the auditor issues an adverse opinion, they may not report on KAMs unless they are required by law or regulation.

Reporting on KAMs is not a substitute for disclosures that are required by the financial reporting framework or otherwise needed for fair presentation. They 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. Nor can they be a substitute for a separate opinion on individual matters.

When the auditor reports on KAMs they should use the subheading "Key Audit Matters" and the opening paragraph should read as noted in the example below. The KAM portion of the report should also discuss details of the key audit manner along with the auditor's audit response.

EXAMPLE

Key Audit Matters

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

The System recognizes revenue upon performance of services specified in contracts with third party payors. Certain of these contracts include variable payments based on quality and other indicators of performance. Significant judgment is exercised by the System in determining revenue recognition for these agreements, and includes the following:

- Determination of whether quality and other performance indicators were met at varying levels that determine the amount of additional payment to which the System would be entitled.
- Recognition of the change in the judgment at which one of the payment levels for the quality and other performance indicators would be met and adjustments for those changes.
- Estimation of the variable consideration related to the quality and other performance indicators.

Based on these factors, the related audit effort in evaluating management's judgments in determining revenue recognition for these customer agreements was extensive and required a high degree of auditor judgment.

Our primary audit procedures related to the System's revenue recognition for these agreements included testing the effectiveness of internal controls related to management's judgment relevant to the quality indicators which form the basis for the variable consideration. We traced the elements used in estimating the quality indicators to reports and communications maintained by the Quality Control department. We performed hindsight review related to previous similar estimates made by management to determine whether they were reasonable. We tested the mechanical accuracy of the computations involved in quantifying the variable payments.

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.

Changes to Other Professional Standards

Communications to Governance (AU-C 260)—The 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 (AU-C 570)—The language has been amended to address the 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."

UNIT 2 Significant Unusual Transactions

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Identify the changes brought about by SAS 135.
- Implement those changes in audits of financial statements.

INTRODUCTION

SAS 135, *Omnibus Statement on Auditing Standards—2019,* incorporates changes to several AU-C sections as illustrated in the chart below.

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

Most of the changes are minor. However, there are substantive 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.* These are areas which have been gaining importance in financial statement audits for years. The common theme is a more two-way communication with those charged with governance especially as it relates to the risk of fraud, significant unusual transactions and related parties.

Minor changes were made to the following AU-Cs. Note that many of them relate to the concept of related parties and significant unusual transactions.

AU-C 210, Terms of Engagement—The auditor is required to 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—The ASB added wording to the standard to refer to significant unusual transactions.

AU-C 510, Opening Balances—The auditor is required to identify related party transactions and significant unusual transactions when evaluating opening balances.

AU-C 580, Written Representations—The ASB added a new representation. It is important that auditors include the new representation about whether any **side agreements or other arrangements (either written or oral) exist that have not been disclosed to the auditor**. The auditor should also consider additional representations related to support for any assertion that a transaction was conducted at arms-length if needed.

AU-C 560, Subsequent Events—The amendment 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—The amendment adds a requirement for the 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 related to significant unusual transactions.

SAS 135 adds several new inquiries and audit procedures related to significant unusual transactions and related parties. These are incorporated in the risk assessment standard, **AU-C 315, *Understanding the Entity, and its Environment and Assessing the Risks of Material Misstatement*** and the standard on performing audit procedures, **AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.***

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:

Stronger Focus on Fraud and Noncompliance:

SAS 147 emphasizes the importance of inquiring about potential fraud or noncompliance with laws and regulations (NOCLAR) before accepting an audit engagement. Once a client grants permission for the prior auditor to respond, the new auditor is required to 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.
- *Noncompliance with Laws and Regulations*: 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).

Similar to prior guidance, the new auditor must assess the predecessor auditor's responses and consider the implications of limited or no response when deciding to accept the engagement.

Additionally, SAS 147 mandates documenting both the inquiries made to the predecessor auditor and the resulting responses.

It's important to note that if a client refuses to authorize the previous auditor to fully respond to inquiries, the new auditor must investigate the reasons behind this refusal and weigh the implications before accepting the engagement.

This amendment to AU-C section 210 is effective for audits of financial statements for periods beginning on or after June 30, 2023. By facilitating a more comprehensive exchange of information regarding potential risks, SAS 147 promotes continuity, enhances the overall quality of the audit process, and enables the auditor to flag potential significant unusual transactions.

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

AU-C 260, *Communication with Those Charged with Governance* addresses the auditor's responsibility to communicate certain matters with governance in planning and at the end of the audit. The objectives of the standard are to:

- 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

Traditionally, audit communication focused on entities with formal board structures. However, a significant portion of the audit landscape comprises privately held companies and not-for-profits lacking such structures. Recognizing this reality, SAS 135 broadens the scope of "those charged with governance" to encompass any individual or organization entrusted with overseeing the strategic direction, accountability, and financial reporting process of the entity. This diverse group could include management personnel, executive board members, or even owner-managers in smaller entities.

SAS 135 elevates the importance of effective communication with those charged with governance, acknowledging their crucial role in safeguarding audit quality. Beyond the customary communication regarding unusual transactions, the standard mandates the communication of the potential impact of uncorrected misstatements on future financial statements: This proactive approach encourages timely identification and mitigation of potential issues before they snowball into significant problems. By bringing potential future consequences to light, auditors empower those charged with governance to make informed decisions and implement corrective actions.

Through this emphasis on enhanced communication, SAS 135 fosters a more collaborative relationship between auditors and those entrusted with overseeing the entity's financial well-being. Clearer and more comprehensive communication not only benefits the audit process by ensuring alignment and transparency but also empowers those charged with governance to fulfill their critical oversight responsibilities more effectively. This ultimately contributes to a more robust financial reporting ecosystem, fostering trust and confidence in the financial health of entities across diverse governance structures.

This section discusses the changes to AU-C 260, not the entire standard.

Significant Unusual Transactions

The auditor is required to communicate significant unusual matters to those charged with governance. The communication of significant unusual transactions may include the auditor's views on the policies and practices management used to account for significant unusual transactions and the auditor's understanding of the business purpose for significant unusual transactions.

The standard does not provide a definition for "significant unusual transaction." However, some additional guidance is useful. The PCAOB's Practice Alert 5, issued in 2010 states that significant unusual transactions, especially when they occur close to period end should the prompt the auditor to question whether fraudulent financial reporting is present. Some indicators to look for are:

- Transactions with unconsolidated related parties that seem outside the entity's business
- Transactions with related special purpose entities
- Transactions that are overly complex
- Transactions involving a large number of intercompany transactions
- Transactions where management is placing more emphasis on the need for a particular accounting treatment than the underlying economics of the transaction
- Transactions that involve 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

It is important to remember that these indicators are a guide to prompt the auditor to ask the question, "Is this transaction one that has a bona fide business purpose? Is the transaction one where management has been transparent, and governance is aware of the transaction? Is the transaction one where related parties are involved? Significance for one audited entity may not be the same for another and not all significant transactions may be unusual.

EXAMPLES

Related Party Transaction Not Disclosed to the Auditor or the Board

During the audit of a manufacturing entity, the keen eye of the auditor caught a seemingly innocuous detail: an increased warehouse rental expense. This seemingly routine cost rise, however, triggered a chain of investigative steps, ultimately revealing a potentially problematic situation.

Initial Inquiry: Upon identifying the increase through preliminary analytics, the auditor enquired about the reason and was informed it resulted from a new lease. However, a crucial discrepancy emerged - the lease agreement was absent from the standard schedule for evaluation.

Raising the Bar: The provided lease document revealed a significant amount of warehouse space in a remote location, seemingly unnecessary given the ample existing space observed during the previous year's physical inventory count.

Further Questions: The auditor's analytical skills came into play again when she noticed a conflicting trend–a decrease in sales. This further questioned the need for additional and costly storage space.

Cost Discrepancies: The newly acquired space boasted a significantly higher rental cost per square foot compared to existing warehouses, raising further concerns:

- 30% higher than the main warehouse (located within the same building as the manufacturing plant)
- 25% higher than the two smaller warehouses conveniently situated near the entity's main customers

Unearthing the Connection: Through diligent investigation, the auditor discovered a startling connection - the newly leased warehouse belonged to a company owned by the board chair. Additionally, the board itself had not formally approved the transaction.

This combination of red flags—the unexplained cost increase, absent lease documentation, questionable location, contrasting sales figures, and potential conflict of interest—collectively led to the classification of this transaction as "significant and unusual." This triggered further discussion with the entity's governance to ensure transparency and address any potential concerns.

This example highlights the crucial role of auditors in diligently scrutinizing even seemingly minor details. By asking the right questions, utilizing analytical skills, and performing thorough due diligence, auditors can uncover potential irregularities and help safeguard the integrity of financial reporting.

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.

Early warning signs emerged during the planning phase. Despite being pre-operational, the company had incurred significant expenses for legal and accounting fees, pre-purchased raw materials, and personnel costs. The balance sheet reflected substantial investments in property, plant, and equipment (PPE) due to ongoing construction and machinery development.

Further complexity arose upon reviewing the consolidated financial statements, which revealed a nine-company group structure, with several entities located overseas. Throughout the year, numerous wire transfers occurred between the parent company and its subsidiaries, documented as intercompany expense payments and reimbursements. However, discrepancies emerged as the intercompany accounts failed to reconcile.

Despite client explanations, the auditor remained unconvinced of the apparent business rationale behind the intricate structure. Additionally, the board, consisting solely of family members of the majority shareholder, raised potential conflict of interest concerns. Considering these combined red flags - pre-operational expenses, significant asset investments, a complex group structure, and unexplained intercompany transactions—the auditor deemed the situation a high risk for potential fraud.

This case underscored the importance of in-depth analysis and heightened vigilance during audits, especially for young companies with unique structures or technologies. Identifying such red flags was crucial to mitigating potential fraud risks and ensuring the integrity of financial statements.

Difficult or Contentious Matters

In addition to significant unusual transactions, the auditor is now required to report matters that are difficult or contentious for which the auditor consulted outside the engagement team and that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process. Matters that are difficult are not always contentious.

Difficult Matter

A difficult matter may be a situation that is challenging either because the client is not cooperative or because the subject matter is challenging and the auditor consults outside the engagement team. For example, a significant estimate may have a high degree of subjectivity and require outside expertise to audit.

EXAMPLE

The auditor of a hospital system consulted with a reimbursement specialist on a significant contract with Medicare. Unlike traditional fee-for-service models, the contract comprised a unique blend of fixed payments and quality-based bonuses. These bonuses, contingent upon meeting specific patient care quality standards outlined in intricate Medicare regulations, were subject to periodic evaluations throughout the three-year contract term.

A significant hurdle arose due to the misalignment between the contract's evaluation periods and the hospital system's fiscal year-end. This temporal mismatch posed a substantial challenge in accurately assessing the potential financial impact of the quality-based bonuses at the time of the audit. Accurately evaluating these bonuses necessitated carefully considering performance metrics accumulated over various periods that fell outside the traditional audit window.

Despite the inherent complexity, the hospital system exhibited commendable transparency throughout the audit process. Management readily provided the auditor with unfettered access to all relevant information used to estimate the quality bonuses. This included comprehensive documentation and all pertinent correspondence exchanged with Medicare, fostering a collaborative environment conducive to a thorough investigation.

Recognizing the limitations of their core competencies in this specialized domain, the auditor proactively engaged a healthcare reimbursement specialist. This specialist possessed in-depth knowledge of the intricacies of Medicare's quality metrics, their precise definitions, and their potential financial implications. The specialist's expertise proved invaluable in deciphering the complexities of the contract and accurately assessing the associated financial risks, ultimately contributing to a comprehensive and reliable audit.

This case serves as a microcosm of the broader challenges auditors encounter in the ever-evolving landscape of healthcare reimbursement. As performance-based contracts become increasingly prevalent, auditors must be equipped to navigate these complexities effectively. This demands not only collaboration with transparent clients but also the willingness to seek specialized expertise when necessary. By embracing a proactive and collaborative approach, auditors can ensure the accuracy and integrity of financial reporting in this intricate domain.

Contentious Matter

A contentious matter is one where there is controversy or a disagreement where consultation was necessary outside the engagement team. Like the difficult matter, not all disagreements would be discussed with those charged with governance, only those that are significant and relevant to those charged with governance's oversight of the financial reporting process.

Professional literature is not always clear and may result in interpretations by the auditor and management that are not the same. There are other times when the client may have a point of view where there is a correct position in GAAP. Either way, the auditor will need to evaluate whether to report the matter to governance in its end of the year communication or earlier if the situation warrants.

> **EXAMPLE**
>
> 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.

Uncorrected Misstatements

The auditor is required to communicate material uncorrected misstatements individually and in the aggregate to governance. If material, the auditor should ask that they be corrected. SAS 135 requires that the auditor highlight those even though they are not material in the current year, could potentially cause future-period financial statements to be materially misstated.

Many misstatements, such as those related to unrecorded liabilities, will turn around in the next year when the amounts are paid. The turn around effect is evaluated by the auditor when determining how important it is to ask the client to correct misstatements that are not material. Other misstatements, such as accruals that are not likely to turn around in the next year may continue to grow as the audited entity grows.

> **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.

Related Party Transactions

Related party transactions are neither good nor bad but due to their nature, there are risks of misstatement or omission in financial reporting involved with them. They have been a topic of focus in professional literature over the last several years and play a prominent role in SAS 135. The ASB amended current literature (AU-C 550) to include guidance from PCAOB AS 2410 to enhance the quality of audits. The enhance requirements require auditors to identify **previously unidentified** or **undisclosed** related party transactions and relationships and perform procedures to test the accuracy and completeness of the related party relationships and transactions identified by the entity. The auditor will present findings, if any, to governance.

The table below highlights the **new** questions that the auditor should ask management and those charged with governance and the **new** procedures that the auditor should perform.

<table>
<tr><th>Inquiries During Risk Assessment Process (AU-C 315)</th><th>Additional Procedures to Perform (AU-C 330)</th></tr>
<tr><td>Enhanced inquiries to management and others within the entity:
■ The nature of the relationships *(including ownership structure)* between the entity and the related parties.
■ *The business purpose of entering into a transaction with a related party versus an unrelated party.*
Whether the entity entered into, *modified, or terminated* any transactions with the related parties during the period and, if so, the type and *business* purpose of the transaction.</td><td>■ Evaluate whether the entity has properly identified its related party relationships and transactions.
■ 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.
■ Perform procedures on balances with affiliated entities as of concurrent dates, even if fiscal years of the respective entities differ
■ Perform additional procedures if necessary.</td></tr>
<tr><th colspan="2">Inquiries During Risk Assessment Process (AU-C 315)</th></tr>
<tr><td colspan="2">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?</td></tr>
<tr><td colspan="2">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?</td></tr>
</table>

Consideration of Fraud

SAS 135 impacts the auditor's consideration of fraud in a financial statement audit by incorporating the changes discussed above related to significant unusual transactions and related parties. These concepts are added into the inquires and other procedures that the auditor performs when considering the risk of fraud. An auditor should consider the following types of transactions:

- 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.

When the auditor identifies significant unusual transactions between related parties or those that fall outside the definition, the auditor should consider evaluating the financial capability of the other party with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees and other obligations.

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.

In the example above, the auditor felt it was necessary to evaluate the collateral. In other cases, the auditor may want to review audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party in order to evaluate significant unusual transactions.

Procedures Performed

SAS 135 also adds procedures to perform when the auditor identifies transactions outside the normal course of business of the entity. The auditor should consider the following:

- Evaluate the rationale and business purpose for those transactions as to whether they suggest that they were entered into in order to perpetrate fraudulent financial reporting or misappropriation of assets.
- 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 regarding the business purpose.
- Determine whether the transaction has been authorized and approved in accordance with the entity's policies and procedures.
- Evaluate whether significant unusual transactions identified have been properly accounted for and disclosed in the financial statements.

NOTES

UNIT

3

Audit Evidence

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- 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.

INTRODUCTION

While the core objective of the Audit Evidence standard—to assess the sufficiency and appropriateness of audit evidence obtained—remains unchanged since its inception, the landscape surrounding that evidence has undergone a significant transformation. This shift is primarily driven by the growing sophistication of technology employed by clients in their financial and operational processes.

Recognizing this evolving environment, the AICPA embarked on a project in 2017 to update the standard. This update aimed to address two key concerns:

- *The impact of technology on audit evidence*: New technologies like data analytics and automation tools have introduced novel ways to gather evidence, necessitating revised guidance for auditors.
- *The need for enhanced professional skepticism*: The AICPA's audit quality initiative, along with observations by the IAASB, highlighted the importance of fostering a more skeptical approach during audits.

SAS No. 142, *Audit Evidence*, represents a substantial leap forward compared to its predecessor, SAS 106 (clarified in SAS 122). The standard expands from a mere 10 pages of guidance to a comprehensive 36 pages, offering a more robust framework for auditors.

Here are some key features of SAS 142:

- *Focus on attributes and factors*: The standard defines a set of attributes and factors that auditors should consider when evaluating all forms of audit evidence, regardless of their source or the method used to obtain them. This includes evidence obtained through automated tools and techniques.
- *Recognition of emerging technologies*: While SAS 142 mentions examples of newer technologies and methodologies, it deliberately avoids in-depth descriptions. This is because the standard prioritizes core principles over specific technologies, ensuring their continued relevance in a rapidly evolving landscape.
- *Emphasis on professional skepticism*: The standard explicitly addresses the importance of professional skepticism throughout the audit process, particularly when dealing with newer technologies.

SAS 142 integrates seamlessly with other, recently issued standards:

- *SAS 143, Auditing Accounting Estimates*: This standard provides guidance on evaluating and auditing accounting estimates made by management.
- *SAS 144, Use of Specialists and Pricing Information Obtained from External Sources*: This standard offers direction on utilizing specialists and incorporating externally sourced pricing information into the audit process.

While each standard occupies a distinct section within the AICPA's Auditing Standards Codification (AU-C), they are all interrelated and should be read and applied comprehensively during an audit.

NOTE: A new update has been issued for compliance audits—SAS 148. This update amends the existing AU-C Section 935 on compliance audits. Here's a breakdown of the key changes:

Modernized Appendix: The appendix listing auditing standards not applicable to compliance audits has been revised to reflect current practices.

Alignment with Recent Standards: SAS No. 148 ensures consistency with recently issued SAS Nos. 142 (Audit Evidence) and 145 (Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement).

The update regarding AU-C Section 501 (Audit Evidence) aligns with the earlier effective date of SAS No. 142 and applies to compliance audits for fiscal years ending on or after December 15, 2022. All other amendments in SAS No. 148 take effect for compliance audits with fiscal years ending on or after December 15, 2023.

Definitions

The following definitions that set the foundation for this unit.

Appropriateness (of audit evidence)—The measure of the **relevance and reliability** of audit evidence. Appropriateness relates to the quality of the audit evidence.

Sufficiency (of audit evidence)—The measure of the **persuasiveness** of audit evidence. The persuasiveness of audit evidence necessary is affected by the auditor's assessment of the risks of material misstatement. Sufficiency relates to quantity.

Audit evidence—Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.

External information source—An individual or organization external to the entity that develops information used by the entity in preparing the financial statements or used by the auditor as audit evidence, when the information is available for use by a broad range of users. When information has been provided by an individual or organization acting in the capacity of management's specialist, service organization, or auditor's specialist, the individual or organization is not considered an external information source with respect to that particular information.

Accounting estimate—A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

Auditor's point estimate or auditor's range—An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate.

Estimation uncertainty—Susceptibility to an inherent lack of precision in measurement.

Management bias—A lack of neutrality by management in the preparation of information.

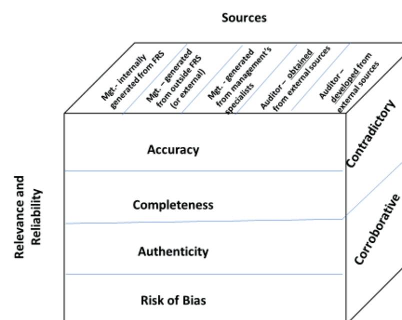
Management's specialist—An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

SAS 142, AUDIT EVIDENCE

SAS 142, *Audit Evidence* is effective for periods ending on or after December 15, 2022. The standard discusses the forms of evidence that auditors have been working with for years. However, the standard presents the information related to evidence that is found in electronic form or new technologies in a more robust way. SAS 142 emphasizes the importance of understanding the quality of the data and accuracy of the reports prepared by management used as evidence, in selecting samples or in performing data analytics.

The key concepts and attributes of audit evidence are summarized in the evidence cube below.

Key Concepts in the Evidence Standard



Relevance and Reliability

As the auditor performs the required procedures during a financial statement audit, they accumulate evidence. The questions to be answered are:

- Is the evidence obtained relevant and reliable?
- Did the auditor consider not only corroborative evidence but also contradictory evidence?
- Did the auditor obtain sufficient appropriate evidence?

SAS 142 explains that the auditor uses attributes and factors in the cube to determine if sufficient appropriate evidence has been obtained.

Relevance

The term relevance has a specific meaning in the context of the evidence standard. Here it refers to how the procedures to be performed are responsive to the account balance/class of transactions and the assertion under consideration. If is also influenced by the period of to which the information relates.

Appropriate Evidence

When evaluating account balances, auditors place significant emphasis on understanding the underlying assertions made by management. These assertions—existence, completeness, valuation, and rights and obligations—represent fundamental claims about the validity of the financial statements.

The quality of audit evidence hinges on both its source and its reliability. Here's a breakdown of this concept:

- *Source*: External sources, such as documentation from a reputable financial institution like a bank or a trusted independent valuation service, generally offer stronger evidence than internal documents. For instance, an electronic document confirming marketable securities held at a custodian bank provides superior proof of existence compared to a record viewed on a blockchain. However, in the case of blockchain, the auditor may be able to establish strong evidence through procedures to confirm the reliability of the specific blockchain platform.
- *Reliability*: Evidence needs to be reliable to be truly meaningful. A confirmation statement from a custodian bank offers reliable evidence of existence, but it doesn't address valuation. To assess valuation, the auditor might turn to external pricing services or published market data.

The specific procedures used by an auditor to test account balances will vary depending on the assessed risk of material misstatement. For a low-risk account like cash with a well-established internal control system, the auditor might rely primarily on reviewing bank statements and reconciliations. This may even involve witnessing the client access the online banking system to directly verify the cash balance.

Confirmations obtained from external parties like banks aren't limited to just verifying account balances (existence). These confirmations can also uncover additional accounts the client may have omitted or shed light on undisclosed liabilities. A comprehensive confirmation request can be a powerful tool for auditors to uncover potential discrepancies.

> **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.

Reliability

The 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. The 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.

Evidence accumulated in testing internal controls could also be derived from written records such as board of director meeting minutes, observation by the auditor, evidence in documentary form such as an approval of an invoice, or orally. It is always appropriate to obtain oral explanations for how a control is performed. Corroboration of an assertion by an employee by an internal or external third party is helpful. But oral evidence alone is not as persuasive as review of documents or observation. And the auditor is required to confirm information obtained by inquiry through other means, such as inspection of documents and records or observation of the application of controls.

Tests of controls are required when information is only available in electronic form or in cases where substantive testing alone would not provide sufficient evidence.

Accuracy and Completeness—Evidence should be tested for completeness and accuracy. Before choosing a sample, the auditor should reconcile the population from which the sample is chosen to the general ledger to ensure completeness. Tests of controls also provide evidence about completeness.

An auditor may also use information developed outside of the financial reporting system as audit evidence. The auditor could use the entity's performance measures for substantive analytical procedures. To ensure that the report with the performance measures is accurate and therefore precise enough to use in a substantive analytical procedure, tests of controls or tests of accumulation of information may be needed.

Authenticity—Auditors are required to consider the possibility of fraud in a financial statement audit. Auditors are not authentication experts but if there is suspicion that a document may be fraudulent the auditor will address this by corroborating the evidence by other means.

Risk of bias—The risk of bias is present in all audits, particularly as it relates to estimates. There are two forms of bias, management bias and auditor bias.

Management bias—There is a higher risk of management bias when information comes from internal sources. There are several considerations here.

- The ability of the entity to influence the external information source
- Management's selection of information so that it "proves" management's assertions
- Management's unknowing use of information from an external source that is biased

EXAMPLE

An audit partner was reviewing a client's estimate for self-insured risks. This estimate involved the valuation of potential liabilities arising from incidents yet to occur. The partner identified several red flags indicating an increased risk of bias in the client's valuation.

Red Flags and Increased Risk of Bias:

- *Management Overconfidence*: The partner suspected the client might be overly optimistic about their ability to defend against potential claims. This could be due to a history of the quality and safety department identifying risks that the client downplayed, believing they could be rigorously defended and wouldn't materialize into claims.
- *Past Misguided Optimism*: The partner's past experience with the client suggested a tendency toward overly optimistic outlooks. This raised concerns about the accuracy of the self-insured risk estimate.

Given these red flags, the partner recognized the need for sufficient and appropriate audit evidence to assess the reasonableness of the client's estimate. This could involve:

- *Reviewing Historical Claims Data*: Analyzing past claims history provides insight into the frequency and severity of incidents. This data can be used to benchmark the current estimate and identify potential inconsistencies.
- *Engaging with the Quality and Safety Department*: Understanding the types of risks identified by this department can shed light on potential under-reserves in the client's estimate.
- *Consulting with a Loss Reserve Specialist*: An independent expert can provide valuable insights into industry best practices for self-insured risk valuation and identify potential weaknesses in the client's methodology.

The scenario highlights the importance of professional skepticism in auditing. By recognizing the potential for bias and taking steps to gather additional corroborating evidence, the auditor demonstrates a critical and questioning mind, a cornerstone of a high-quality audit.

Auditor bias—Auditor's bias may actually be more challenging to address. The auditor's judgment may be hampered by:

- **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.

Sources of Evidence

The top of the evidence cube identifies five sources of evidence which the auditor can use singly or in combination. They can be summarized from two sources.

Management—Generated internally from the financial reporting system or generated outside the financial reporting system, including from sources external to the entity. It is important to distinguish information obtained from outside the entity that is available to the general public or through a paid service but benefitting many from information obtained from management's specialists.

Auditor—Obtained from sources external to the entity or developed from sources internal or external to the entity.

EXAMPLE

An auditor was reviewing the audit evidence used by management to estimate the Accumulated Benefit Obligation (ABO) for a defined benefit pension plan. The ABO represents the present value of the benefits earned by employees as of the valuation date. The estimate relied on two key sources of information:

- *Internal Data*: This included employee data like salaries, service history, and retirement eligibility pulled from the entity's financial reporting system.
- *Actuarial Report*: Management engaged an actuary, considered a specialist according to auditing standards, to perform calculations and provide an estimate of the ABO.

Testing Management's Data:

The auditor recognized the importance of verifying the accuracy of the internal data used in the calculation. This might involve:

- *Tracing a sample of employee data* from the financial reporting system to the actuary's report to identify any discrepancies.
- *Performing analytical procedures on the data* to identify potential anomalies, such as unexpected trends in salaries or employee demographics.

Evaluating the Actuary's Work (AU-C 501):

Since the actuary qualifies as a management specialist under AU-C Section 501, *Audit Evidence*, the auditor needs to assess the actuary's competence, the reasonableness of their assumptions, and the appropriateness of their methodologies. This could involve:

- Obtaining and understanding the actuary's qualifications and experience.
- Reviewing the actuary's assumptions about discount rates, mortality rates, and expected employee turnover, comparing them to industry benchmarks and economic data.
- Evaluating the actuarial methodology applied to calculate the ABO, ensuring it aligns with GAAP and actuarial standards of practice.
- Discussing any discrepancies identified with the actuary and management to obtain a clear understanding and adjust the estimate if necessary.

By employing a two-pronged approach–verifying the internal data and evaluating the actuary's work–the auditor gathers sufficient and appropriate audit evidence to assess the reasonableness of the ABO estimate. This ensures the financial statements accurately reflect the company's pension obligations.

Internal Information

In the past much of the internal information requested by an auditor consisted of source documents such as checks, invoices, contracts, ledgers, journal entries, spreadsheets, cost allocations, computation, reconciliations, and disclosures, generally found in paper form. With the many advances over the years in information technology, a significant amount of evidence is now in electronic form either having been transmitted to or from the client electronically or scanned in when received. Other internal forms of data might come from outside accounting in the form of sales, marketing or other system generated reports.

Auditors traditionally performed manual testing of internal controls and substantive testing along with straightforward analytical procedures using computer aided audit techniques. However, as companies and their systems and processes have become more complex and clients embrace newer technologies, auditors are, in many cases, expected to do the same. Even smaller companies are turning to paperless systems causing a shift in auditing requirements. When information is only available in electronic form, it is less likely that substantive tests alone with provide sufficient evidence so controls should be tested.

Automated Techniques Audit Data Analytics

Automated techniques have been used by auditors in some form for many years. Typical automated techniques used by auditors are:

- Foot journals and ledgers to determine accuracy
- Choose journal entries
- Scan data to identify anomalies
- Identify samples for testing

Auditors will often use data analytics in performing substantive analytical procedures. Audit data analytics is described as a technique that analyzes patterns, identifies anomalies, or extracts information from data through analysis, modeling, or visualization.

Some of the data used in these tests is financial and some is operational. For example, if an auditor wants to test retail sales by regression analysis, they may obtain information about square feet in the retail store and sales prices from management (internal) and changes in the consumer price index (external). The regression analysis is only as good as the accuracy of the inputs and the soundness of the auditor's assumptions (that is that square feet and sales prices are good predictors of sales).

Regression analysis is a technique that it is used to model the relationship between an independent and dependent variable. The auditor can use it to predict anomalies. This and other data analytics can be very simple or when using many variables, become more complex. For example, clients may use artificial intelligence such as machine learning to predict outcomes and forecast liabilities. Client specialists may use models such as Black Scholes as predictive tools.

These more sophisticated analytics are not without risk. If the data is not relevant and reliable the test will not provide appropriate evidence. Auditors need to 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. They also need to be skilled in the application used to perform the test.

Since auditors and clients have been performing audit data analytics in some form for years, they are widely accepted methodologies. SAS 142 mentions other techniques that can be used by auditors but does not go into detail describing them. These are briefly described here:

Artificial Intelligence (AI) is a set of algorithms that perform work that traditionally requires human intelligence. The 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.

Machine learning is a type of AI. Machine learning feeds a computer with data and uses statistical techniques to help it "learn" how to get progressively better at a task. For example, if 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.

Robotic process automation (RPA) is a technology application that automates routine business. An entity can use this tool to capture and interpret 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. For example, 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.

Remote observation tools such as drones can be used for many applications such as to count inventory in difficult to reach places.

Automated techniques may also be used both as risk assessment procedures and as substantive procedures concurrently if the objectives of both types of procedures are achieved.

External Information

External information can be more challenging to test since the 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.

It is important to make the 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.

An 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.

EXAMPLES

In the world of valuations, actuaries can play a dual role. When they're directly involved in calculating specific client liabilities, like pension obligations or claims payable, they act as an internal specialist for that client. In this scenario, their work is considered part of the client's information and wouldn't be viewed as an external source by an

> auditor. However, the actuary's expertise extends beyond individual clients. Actuarial firms can also function as external data providers. When they publish industry-wide data on mortality rates, life expectancies, or other relevant information, this published data becomes a valuable resource for auditors and other professionals. This distinction between internal specialists and external data providers is crucial for understanding how actuarial information is used in the financial world.
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> The role of valuation specialists, like those using Black-Scholes models for unlisted derivatives, hinges on whether they cater to specific clients or provide publicly available information. When engaged by a company to directly value a derivative instrument for their financial statements, the specialist acts as **management's specialist**. Their work becomes part of the client's information and isn't considered an external source for auditing purposes.
>
> However, the same valuation company can also function as an **external source**. This happens when they publish valuation models or data (like Black-Scholes parameters) applicable to a broader market. If a company then utilizes this publicly available information within its own estimation methods for derivatives, the valuation company wouldn't be considered a management specialist. In this scenario, the company has leveraged an external resource to inform its internal valuations.

The auditor should consider the relevance and reliability of the information no matter whether it was obtained by management or the auditor by considering:

- 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
- 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
- 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.

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 decide to 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. If alternate evidence cannot be found, then the opinion may have to be modified.

Evaluating Information Used as Audit Evidence

Audit evidence can take many different forms depending on how it is accumulated. Different forms of evidence include:

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.
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.

Corroborative or Contradictory Information

AU-C 330 states that 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.

> **EXAMPLE**
> 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.

Audit Procedures

Auditors gather evidence through a multi-pronged approach, including risk assessments, tests of controls (when applicable), and substantive procedures like tests of details and substantive analytical procedures. Today's digital landscape presents both challenges and opportunities for auditors.

Data Availability and Retention:

- *Limited access*: Information may be solely available electronically or only accessible during specific periods. This can impact testing strategies. For instance, inadequate data retention policies might necessitate requesting the client to preserve crucial information that can be reviewed later. Alternatively, the auditor might adjust the timing of procedures to coincide with data availability.
- *Continuous access*: Certain electronic data, like blockchain records, is continuously accessible throughout the audit. This facilitates the use of data analytics and artificial intelligence tools to glean real-time transaction insights.

A plethora of audit procedures exist to examine information, including inspection, observation, confirmations, recalculations, reperforming procedures, analytical procedures, and inquiries. Auditors select procedures based on effectiveness and efficiency. Some procedures are well-suited for manual testing, while others lend themselves better to automation.

Inquiry plays a vital role in the audit process, potentially prompting further testing in specific areas. However, it's crucial to remember that inquiry alone doesn't constitute sufficient audit evidence.

Testing Controls Over Information to Be Used as Audit Evidence

Testing internal controls becomes even more important when the information is electronically initiated, recorded, processed, or reported and is only available in electronic form. Here the sufficiency and appropriateness of the evidence usually depends on the effectiveness of controls related to data accuracy and completeness. When the source documents are electronic there is more risk that the documents could be inappropriately initiated or altered, and the fraudulent activity remain undetected.

Inspection

Auditors have always performed physical inspection of assets and documents. Over the years, things have evolved so that the documents are now, in large part, in electronic form. An automated technique that is being used currently is artificial intelligence programs that use text recognition programs to examine documents. These programs identify items for further audit consideration.

Observation

Observation consists of looking at a process or procedure being performed by employees. One example is the observation of inventory. Where this can be a manual process, automated tools and techniques such as use of drones not only assist but can add accuracy to a process.

External Confirmation

An external confirmation is a direct response knowingly provided to the auditor by a third party (the confirming party).

Recalculation

Recalculation consists of testing the mathematical accuracy of information. Recalculation may be performed manually or using automated tools and techniques. Auditors have been using technology to recalculate reports as well as foot the general ledger.

Reperformance

Reperformance involves the independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Analytical Procedures and Use of Audit Data Analytics

Auditors are required to use analytical procedures at an overall financial statement risk assessment procedure. These analytics are performed at a high level. Auditors also use them as substantive tests to test revenue and expenses. The substantive analytics are performed with a higher rate of precision since they provide evidence about an account balance or class of transactions.

Auditors scan the general ledger to look for significant or usual items to test. Auditors can use programs to perform data analytics that will help them extract data that meet certain parameters. This could mean transactions ending in round numbers or transactions that are right above a dollar value required for additional approval, etc. The auditor can use these tools to run Benford's law, an algorithm that predicts anomalies in a population based on the expected frequency and placement of numbers in a monetary transaction.

Use of Information for More Than One Purpose

An auditor may use information for more than one purpose provided that the characteristics are suitable for both purposes.

> **EXAMPLES**
>
> During an entity-level internal controls test, an auditor retrieved information from the internal audit department. This information documented the client's monitoring activities. Recognizing its potential value, the auditor considered using it for a substantive analytical procedure (SAP).

However, before incorporating this information into the SAP, the auditor undertook a critical evaluation. This assessment focused on ensuring the information met the specific needs of the SAP:

- *Sufficiency of Detail*: The auditor needed to confirm whether the internal audit information provided enough granular details to support the intended substantive analytical procedure. For instance, if the substantive analytical procedure aimed to assess trends in inventory shrinkage, the information should offer specifics beyond just the existence of monitoring procedures.
- *Precision of Data*: The auditor also needed to assess the precision of the data within the information. This could involve verifying the accuracy of any metrics or percentages reported by the internal audit department.

Only after this evaluation could the auditor determine if the internal audit information possessed the necessary detail and precision to be a reliable source for the substantive analytical procedure.

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An auditor planned to utilize data analytics as a risk assessment tool. The goal was to identify red flags–unusual transactions, events, amounts, ratios, and trends–that might point toward areas with an increased risk of material misstatement.

The auditor discovered that visualizing transactional data proved particularly effective in spotting anomalies. To achieve this, they created an analytical tool that displayed sales data visually. This visualization highlighted both per-unit values and the total number of items within the data set (population).

The initial objective of this procedure was risk assessment. However, upon closer examination, the auditor recognized that the analysis produced precise and reliable information. This revelation opened the door for a secondary use–incorporating the output into an SAP. By leveraging the insights gleaned from the visualization, the auditor could further refine the audit approach and strengthen the overall audit evidence.

Inquiry

Inquiry consists of seeking information, both financial and nonfinancial, from knowledgeable persons within the entity or outside the entity. Auditors use inquiry throughout the audit, coupled with other audit procedures. Evaluating responses to inquiries is an integral part of the inquiry process. Corroboration helps to confirm what one person has told the auditor. Often this is used in an understanding of internal control.

Documentation

Audit documentation is very important in all audits but particularly where new audit techniques are used. It is highlighted by the ASB as an important component of SAS 142. However, AU-C 230 was not amended as a result of the standard.

SAS 144, USE OF SPECIALISTS AND PRICING INFORMATION OBTAINED FROM EXTERNAL SOURCES

SAS 144 amends three AU-C sections, AU-C 501, Audit Evidence, Specific Considerations for Selected Items, AU-C 540, Auditing Accounting Estimates and AU-C 620, Using the Work of an Auditor's Specialist. It is effective for periods ending on or after December 15, 2023.

This standard was issued primarily to respond to feedback asking for additional guidance on auditing the fair value of financial instruments although certainly, management and auditors use specialists for other areas as well. Pricing services are extensively used in the area of investments, also causing an interest for the ASB to pursue this topic.

SAS 144 also:

- Provides guidance in on applying SAS No. 143, which is effective on the same date, 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.

Use of Management's Specialist—Amendments to AU-C 501

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. SAS 144 amends AU-C 501 in that it defines **management's specialist** as an 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. It also clarifies that it is no longer appropriate to refer to using the work of an external inventory-taking firm as using the work of a management's specialist.

Most aspects of the topic, use of management's specialist have **not** changed. The standard still states that 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

Management may engage external organizations that who have expertise in the taking of physical inventories to count, list, price, and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. For example, such external inventory-taking firms are often used by entities such as retail stores, hospitals, and automobile dealers. This is **not** considered management's specialist.

Pricing Information from Third Parties as Audit Evidence

Auditors may choose to use information from a third-party pricing service as evidence to support management's estimates on financial instruments with or without readily determinable fair values. Information from an external pricing service is more reliable than internal information because it is less susceptible to management bias. The appendix in AU-C 540, *Auditing Accounting Estimates and Disclosures* provides additional guidance on how to evaluate the work of a pricing service. Excerpts of this guidance can also be found in AU-C 501.

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 testing the valuation of marketable securities, information from the reputable pricing service may be sufficient. However, if the valuation is of a complex derivative, more work may need to be performed.

EXAMPLE

An auditor was tasked with evaluating the valuation assertion for a client's investment portfolio. This involved testing the fair value of various instruments, including those listed on national exchanges and OTC markets.

The auditor was fortunate to locate quoted market prices for many of the derivatives and securities within the portfolio. These prices were sourced from reputable external sources:

- *Public Exchanges*: The auditor obtained pricing data for listed securities directly from stock exchanges like NASDAQ. This information is considered reliable because it reflects real-time market activity accessible to all participants.
- *External Pricing Services*: The auditor also utilized pricing data from established external pricing services. These services provide fair value estimates for instruments that may not be actively traded on exchanges.

Since the obtained pricing information originated from external sources readily available to the public, and the instruments were not unique or illiquid (not routinely priced), no further procedures were deemed necessary to corroborate the fair value of the client's investments. This approach aligns with auditing standards, which acknowledge the validity of using publicly available market data for valuation purposes when it's relevant and reliable.

Pricing services routinely provide uniform pricing information to users, generally on a subscription basis. 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. However, when a pricing service is engaged to individually develop a price for a specific financial instrument that not routinely priced for its subscribers the requirements for using that information as audit evidence may also involve the guidance in *Audit Evidence—Specific Consideration for Selected Items* (use of management's specialist) or AU-C 620, *Using the Work of an Auditor's Specialist*.

Pricing Service Information—Considered to Be from an External Source

When the auditor uses information from external sources the following should be considered when evaluating the relevance and reliability of the information:

- the experience and expertise of the pricing service relative to the types of financial instruments being valued
- whether the types of financial instruments being valued are routinely priced by the pricing service

- 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 applicable financial reporting framework
- whether the pricing service has a relationship with the entity by which management has the ability to influence the pricing service

It is important to note that 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.

Information Tested at an Interim Date

If the auditor performs procedures to assess the relevance and reliability of pricing information provided by a pricing service at an interim date, they should determine if it necessary to evaluate whether the pricing service has changed its valuation process after the interim date evaluated. The auditor will also want to understand whether transactions have occurred after the valuation that may have an effect on the amount 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.

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. The auditor should evaluate:

- 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

Unobservable Inputs

When the valuation of a financial instrument includes unobservable inputs that are significant to the valuation, the auditor should obtain an understanding of how those inputs were determined and evaluate their reasonableness. The auditor should consider whether modifications made to observable information reflect the assumptions that market participants would use when pricing the financial instrument, including assumptions about risk and how management determined its fair value measurement, including whether it appropriately considered the information that was available.

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.

Using Pricing Information from Multiple Pricing Services

When pricing information is obtained from more than one pricing service, the auditor has the opportunity to compare information. If the valuations are comparable, less information may be needed about the particular methods and inputs used by the individual pricing service. In making this determination the auditor would consider:

- Are there are recent trades of the financial instrument or of financial instruments substantially similar to the financial instruments being valued?
- Do the pricing services routinely price the financial instruments?
  - Are the prices obtained are reasonably consistent across pricing services given the nature and characteristics of the financial instruments being valued as well as the market conditions?
  - Is the pricing information for the type of financial instrument generally based on inputs that are observable?

If none of these factors are present then the auditor may be required to perform further audit procedures.

Using Pricing Information from a Broker or Dealer

When a fair value measurement is based on a quote from a broker or dealer (broker quote), another set of considerations apply. The broker may be a market maker in the stock. A market maker is a firm that actively quotes in a particular security, providing bids and offers, referred to as asks, along with the market size of each. Market makers are helpful in the market because they provide liquidity to it. They make profit from the bid-ask spread. They may also make trades for their own accounts.

When dealing with situations where the information is being provided by a broker/dealer the auditor will want to determine whether the entity:

- has a relationship with the reporting entity resulting in the possibility that management has the ability to influence the broker or 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 date of the financial statements
- quote is binding on the broker or dealer

The auditor also needs to determine if there are any restrictions, limitations, or disclaimers in the broker quote and, if so, their nature.

Quotes from a broker provide better evidence when they are timely, binding quotes, without any restrictions, limitations, or disclaimers and when the broker is not a market maker transacting in the same type of financial instrument. If the broker quote does not provide sufficient appropriate audit evidence, then the auditor may need to perform additional procedures.

> **EXAMPLE**
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> An auditor was reviewing the valuation of a client's investment portfolio. This portfolio contained securities that were not actively traded, making their fair value determination more complex. The client relied on pricing information provided by their broker to value these illiquid securities.
>
> However, the auditor identified a potential conflict of interest. Upon inquiry, the client revealed that the broker acted as a market maker for one of the specific illiquid securities. Market makers facilitate trading by providing bid and ask prices, but these prices may not always reflect true market value, especially for less liquid assets.

> Given this potential conflict, the auditor decided to obtain pricing information from an alternative source. This source would ideally be an independent pricing service with expertise in valuing illiquid securities. By leveraging an objective third-party source, the auditor could gather more reliable evidence to support the fair value of the client's investments.

AU-C 620, Use of an Auditor's Specialist

AU-C 620 addresses the use of the auditor's specialist to make it more robust and enhance the quality of audits. As noted earlier there may be times when the auditor engages a specialist to assist in addressing concerns they may have relative to using the work of management's specialist. These concerns may arise due to:

- the nature, scope, and objectives of the work of the management's specialist
- whether the management's specialist is employed by the entity or is a party engaged by it to provide relevant services
- extent to which management can exercise control or influence over the management's specialist (including, when applicable, the organization that employs the individual specialist)
- competence and capabilities of the management's specialist
- whether management's specialist is subject to technical performance standards or other professional or industry requirements
- 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

The auditor should evaluate the objectivity of their specialist and inquire as to whether the specialist has had a role in preparing the subject matter or has other conflicts of interest that reduce the level of objectivity. In these cases, there may not be any safeguards that can reduce the threats to an acceptable level. The auditor should identify another specialist.

When working with a specialist the auditor and the specialist should discuss and agree on their respective roles and responsibilities. This might include:

- Whether the auditor or the auditor's specialist will perform detailed testing of source data
- Degree of responsibility of the auditor's specialist for the testing of data produced by the entity, or evaluating the relevance and reliability of data from sources external to the entity
- Evaluating the significant assumptions used by the entity or management's specialist, or developing the auditor's specialist's own assumptions
- Evaluating the methods used by the entity or management's specialist, or using the auditor's specialist's own methods
- Consent for the auditor to discuss the findings or conclusions of the auditor's specialist with the entity and others and to include details of the findings or conclusions of the auditor's specialist in the basis for a modified opinion in the auditor's report, if necessary
- Agreement to inform the auditor's specialist of the auditor's conclusions concerning the work of the auditor's specialist

Generally, when an auditor hires a specialist it will be because the topic area involves the use of significant assumptions and methods. In those cases, the evaluation of the appropriateness and reasonableness of those assumptions and methods used and their application are the responsibility of the auditor's specialist.

The auditor should obtain an understanding of those assumptions and methods and evaluating the relevance and reasonableness of those assumptions and methods. The auditor should consider:

- Whether the assumptions and methods are generally accepted within the field of the auditor's specialist
- 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 specialists 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.

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

An auditor encountered a challenge: her firm lacked the in-house expertise to value certain complex securities material to the client's financial statements. To address this gap, she decided to engage a valuation specialist with the requisite knowledge and experience.

Recognizing the importance of objectivity, the auditor meticulously planned her collaboration with the specialist. The plan included:

- *Independence Check*: Through inquiry, the auditor confirmed that the specialist had no conflicts of interest or undue familiarity with the client, ensuring their impartiality in the valuation process.
- *Division of Responsibilities*: A clear division of tasks was established. The audit team would focus on scrutinizing the underlying source data used for valuation. This involved:
  - *Data Verification*: The auditor meticulously verified the data's accuracy.
  - *Internal Control Assessment*: An understanding of the client's internal controls over data collection and maintenance was obtained to assess the data's reliability.
  - *Completeness and Consistency Review*: The data were reviewed for completeness and internal consistency to identify any potential anomalies.
- *Valuation Methodology Review*: After the auditor completed their procedures on the source data, a collaborative session was held with the specialist. During this session, the specialist thoroughly explained their valuation methodology, ensuring transparency and alignment with valuation standards.

By performing these comprehensive procedures, the auditor gained sufficient assurance regarding the specialist's work. This meticulous approach minimized the risk of overlap and redundancy between the auditor's and specialist's efforts, promoting efficiency. Ultimately, the auditor felt confident that the valuation specialist's work was reliable and appropriate, eliminating the need for further extensive procedures.

SAS 143, Auditing Accounting Estimates and Related Disclosures

SAS 143, *Auditing Accounting Estimates and Disclosures* was revised, primarily to conform with the international standard dealing with accounting estimates. It is timely in that the 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. Although SAS 143 applies to all accounting estimates, including fair value estimates, the degree of estimation uncertainty varies widely from situation to situation.

Nature of Estimation and Uncertainty

Management makes accounting estimates when it is not possible to directly observe a monetary amount for the account balance. The term estimate implies that there are inherent limitations in knowledge or data and that judgment is necessary to select and apply an estimation method using various assumptions in data to calculate the estimate. There is inherent subjectivity and variation in measurement outcomes. Some estimates are very simple, such as an estimate for depreciation. Other estimates, such as an estimate for uncollectible accounts receivables, the fair value of alternative investments, a reserve for claims incurred but not reported and others are more complex and contain more estimation uncertainty. It is important to understand the concept of estimation uncertainty. Estimation uncertainty is the susceptibility of an estimate to an inherent lack of precision in measurement.

There are many accounting estimates that do not require the application of specialized skills or knowledge. For example, a depreciation calculation or evaluating a reserve for obsolescence in a retail environment may not require any specialized knowledge and skill. However, an estimation for expected credit losses for a financial institution or claims incurred but not reported for an insurer may involve a high degree of estimation uncertainty. The auditor will evaluate inherent risk in the estimates considering uncertainty, complexity, or other risk factors.

EXAMPLES

An auditor was evaluating a financial institution's reserve for credit losses. This reserve represents the estimated amount of future losses on loans and other financial instruments. The auditor identified several red flags that warranted additional audit work:

- *Model Complexity*: The model used to calculate the reserve was intricate, potentially harboring hidden flaws or limitations.
- *Heavy Reliance on Historical Data*: The model's dependence on historical loss data raised concerns. Past performance doesn't always accurately predict future economic conditions that may impact credit losses.
- *Inherent Estimation Uncertainty*: The very nature of credit losses makes them inherently difficult to predict with absolute certainty.
- *Management Bias Risk*: Management's inherent desire to present a positive financial picture could lead to underestimating potential losses.

These factors combined—model complexity, reliance on historical data, estimation uncertainty, and potential management bias—all pointed toward a high degree of estimation uncertainty in the credit loss reserve. As a result, the auditor deemed it necessary to perform additional and potentially more extensive audit procedures to gather sufficient and appropriate audit evidence in this critical area.

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> An auditor was reviewing a litigation contingency estimate for a home health company. Unlike the auditor's experience with other healthcare clients, this company had a limited history of lawsuits. This lack of experience meant management wasn't well-versed in making such estimates.
>
> While the estimate itself wasn't complex—it essentially hinged on a single, critical judgment about the potential liability—it carried a high degree of estimation uncertainty. This uncertainty stemmed from the company's limited litigation history, making it difficult to accurately predict the likelihood and cost of a potential lawsuit.
>
> Despite the apparent simplicity of the estimate, the auditor recognized the high level of uncertainty. This recognition would likely lead to additional audit procedures to gather sufficient and appropriate evidence to support the reasonableness of the litigation contingency estimate.

Assessing the Risk of Material Management Estimates

As part of the risk assessment process the auditor obtains an understanding of the entity and its environment including its internal control. SAS 143 states that the auditor is required to understand the transactions and other events that give rise to accounting estimates. This includes understanding the entity's internal control over management estimates which is a significant factor in assessing risk. In addition to internal controls over the inputs to accounting estimates and the expertise of those forming the estimates, the auditor is concerned about management bias.

Management bias is the lack of neutrality by management in the preparation of information. This is not necessarily intentional. Management may have an artificially high opinion of the ability of customers, clients, donors, etc. to pay. This may be optimism. It may also be lack of understanding of the critical nature of accounting estimates to the user of the financial statements. As a worst case, it could be a deliberate intent to misstate the financials to show an improved result of operations, meet a debt covenant or affect executive compensation. As discussed in the section on the evidence standard, the auditor should maintain a high degree of skepticism and challenge the documentation provided to them.

Assessing Inherent and Control Risk

AU-C 143 requires the auditor to separate inherent and control risk when making the evaluation of the risk of material misstatement as it relates to estimates. Note that SAS 145, *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement* which is effective at the same time requires this separate evaluation for all relevant assertions.

Inherent Risk

Inherent risk, the susceptibility of an account balance, class of transaction, or disclosure to material misstatement before considering internal controls, varies across different assertions. The impact of inherent risk factors determines its severity, forming a "spectrum of inherent risk" as described by the Statements on Auditing Standards.

For accounting estimates, inherent risk is particularly influenced by three key factors:

- *Estimation Uncertainty*: The inherent difficulty in accurately predicting future events or outcomes. Highly subjective estimates with limited historical data to draw from will naturally carry a higher inherent risk.

- *Method, Assumptions, and Data*: The complexity and subjectivity involved in selecting and applying methodologies, assumptions, and underlying data can significantly impact the reliability of the estimate.
- *Management's Judgment*: The accuracy of management's point estimate and the related disclosures ultimately depend on their judgment. Situations, where management has a strong incentive to manipulate the estimate (e.g., pressure to meet financial targets), will elevate inherent risk.

While the objective is not to criticize past estimates made with the best available information at the time, reviewing prior period accounting estimates can be a valuable tool in inherent risk assessment. This review can help the auditor:

- *Identify Trends*: Consistent over- or underestimation in past periods might signal a potential bias in management's approach.
- *Evaluate Complexity*: The presence of complex estimates in prior periods could necessitate engaging team members with specialized skills to address them effectively during the current audit.

By understanding the inherent risk spectrum and its specific impact on accounting estimates, the auditor can tailor their procedures to areas with greater potential for misstatement. This targeted approach optimizes audit efficiency and effectiveness.

Control Risk

Control risk, separate from inherent risk, focuses on the internal controls designed to mitigate the risk of material misstatement in accounting estimates. The auditor first seeks to understand these controls and then determines whether testing is necessary.

Control risk can only be reduced below high if the tests confirm the effectiveness of the controls.

Here's a breakdown of key internal controls to consider:

- *Governance and Oversight*: The auditor should assess the nature and extent of oversight provided by the entity's governance structure over the financial reporting process, particularly concerning accounting estimates.
- *Specialized Skills and Knowledge*: How does management identify the need for and utilize specialized skills or knowledge related to accounting estimates? This includes situations where management engages a specialist.
- *Risk Assessment Process*: Does the entity's risk assessment process effectively identify and address risks specific to accounting estimates?
- *Information Systems and Accounting Estimates*: The auditor should evaluate how the entity's information systems handle accounting estimates. This includes considering whether the estimates arise from routine transactions (e.g., depreciation) or non-recurring and unusual events.
- *Completeness and Disclosure*: How does the information system ensure the completeness of accounting estimates and related disclosures, particularly for liabilities?
- *Selection of Methods, Assumptions, and Data*: A critical element in creating a management estimate involves selecting appropriate methods, assumptions, and data sources. The auditor should understand how management:
  - Selects or designs and applies estimation methods, including models.
  - Selects and justifies assumptions used, considering alternatives and identifying significant ones.

- Chooses the data to be used.
- Assesses the degree of estimation uncertainty, including the range of possible outcomes.
- Addresses the estimation uncertainty by selecting a point estimate and preparing related disclosures.
- Reviews and responds to the results of prior period accounting estimate reviews.

By understanding these controls and how management approaches accounting estimates, the auditor can make informed decisions about the need for, and the extent of, control testing procedures. This targeted approach allows the auditor to efficiently gather sufficient audit evidence and support the reasonableness of the accounting estimates in the financial statements.

Enhanced Risk Assessment Requirements

SAS 143 provides enhanced risk assessment requirements tailored to estimates, with a special focus on how complexity, subjectivity, and estimation uncertainty are considered in identifying and assessing risks of material misstatement.

The auditor should perform a hindsight review during the risk assessment process to evaluate the outcome of previous accounting estimates, and any subsequent re-estimation, to assist in identifying and assessing the risks of material misstatement in the current period. The auditor considers the characteristics of inherent risk in determining the nature and extent of that review.

Once the auditor has assessed the risk of material misstatement, including any significant risks, the auditor should design and perform tests responsive to those risks. SAS 143 states that further audit procedures should specifically respond to the reasons for the assessed risks of material misstatement.

For an estimate that the auditor has deemed a significant risk, the auditor's further audit procedures should include tests of controls in the current period if the auditor plans to rely on those controls. And if the auditor does not intend to rely on controls, they must still obtain an understanding of controls. Note that the definition of significant risk has changed with the effective date of SAS 145. A significant risk is a risk that is at the high end of the spectrum of inherent risk.

EXAMPLE

An auditor at a pork production company was tasked with assessing the inherent risk associated with significant management estimates. One estimate stood out–the unborn pig accrual. This complex and sizeable estimate also carried high degree of estimation uncertainty, raising significant risk concerns for the auditor.

Following the guidance outlined in SAS 143, the auditor undertook a multi-pronged approach to evaluate the unborn pig accrual:

Understanding Internal Controls:

- *Management Override Risk*: A red flag emerged–the CFO solely created the estimate without any review by another party. This heightened the auditor's concern about potential management bias.

Testing the Estimate:

- *Tracing Inputs*: The auditor meticulously traced the key inputs used in the calculation back to their source–historical records and other relevant documentation.
- *Corroborating Assumptions*: Certain assumptions were corroborated through discussions with operations personnel, lending credibility to those aspects of the estimate.
- *Hindsight Review*: The auditor evaluated the accuracy of the prior year's unborn pig accrual estimate, providing valuable insight into the effectiveness of past estimation methods.

Evaluating Reasonableness:

The auditor didn't simply accept the client's estimate at face value. A comprehensive evaluation was conducted to assess its overall reasonableness:

- *Quantitative Analysis*: The auditor likely performed calculations and analyses to assess whether the estimate fell within a reasonable range based on industry benchmarks or historical data (adjusted for expected changes).
- *Qualitative Factors*: Considerations beyond just numbers were likely factored in. For example, the auditor might have reviewed the company's breeding herd health, mortality rates, and overall production plans to see if they aligned with the assumptions embedded in the estimate.

Disclosure Assessment:

Finally, the auditor ensured that the disclosures related to the unborn pig accrual were clear, concise, and met the requirements of professional auditing standards. This transparency allows financial statement users to understand the inherent uncertainties associated with this critical estimate.

By employing a combination of these procedures, the auditor gathered sufficient and appropriate audit evidence to support the valuation of the unborn pig accrual in the client's financial statements.

When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details. For example, tests of details for an accounting estimate for significant risks include examining contracts to corroborate terms or assumptions, recalculation and agreeing assumptions used to support documentation.

Concept of Reasonableness

Disclosures are very important in the context of significant accounting estimates. Therefore, the auditor considers not only the reasonableness of thee estimate, but the reasonableness of the disclosures as well. The concept of reasonable includes:

- whether the data and assumptions used in making the accounting estimate are consistent with each other
- how the data and assumptions are consistent with those used in other accounting estimates or areas of the entity's business activities.

Management will record a point estimate in the books and records but may also have computed a range which may be small or quite wide. The auditor will develop their own estimate to evaluate management's point estimate and disclosures. The auditor will evaluate the evidence obtained and determine if it is sufficient to support the reasonableness of the point estimate or the range.

If that auditor does not agree with management's point estimate and believes it is not reasonable, they should discuss the reasons with management and explain why they believe an adjustment is necessary. If management still does not agree then the difference between management's point estimate and the auditor's is considered a misstatement. When the auditor's estimate is a range then the misstatement is the difference between management's point estimate and the nearest point of the auditor's range.

The footnotes should contain descriptive information that describe the level of estimation uncertainty for significant estimates. The auditor considers the audit evidence obtained about disclosures as part of the overall evaluation of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated.

Based on the procedures performed and evidence obtained, SAS 143 requires the auditor to evaluate whether the accounting estimates and related disclosures are reasonable or whether they are misstated.

When evaluating an estimate, the auditor should be aware of the financial reporting requirements. For example, ASC 820, *Fair Value Measurement,* states that if multiple valuation techniques are used to measure fair value then the results should be evaluated considering the reasonableness of the range of values that were the outcome of the measurements. On the other hand, ASC 450, *Contingencies,* states that when recognition criteria are met and the reasonably estimable loss is a range where one point is no better of an estimate than any other, the minimum amount in the range is required to be accrued.

Concluding About Accounting Estimates and Whether They Are Reasonable or Misstated

Based on the evidence obtained the auditor will determine whether the accounting estimates and disclosures are reasonable in the context of the financial reporting framework. AU-C 450, *Evaluation of Misstatements Identified During the Audit,* provides more detailed guidance on how the auditor evaluates the effect of uncorrected misstatements.

Should there be a significant difference in the auditor's assessment of the estimate and management's, the auditor's first step is to ask management to review the assumptions and methods used in the estimate. Judgmental misstatements are differences arising from the judgments of management and those of the auditor. These are different from factual misstatements, where there is no doubt and projected misstatements, which are the auditor's best estimate of the misstatement in the population where audit samples were drawn.

The auditor will consider whether the difference in their judgments and management's is something that may have resulted from bias. If bias is deliberate, the auditor may need to consult AU-C 240, *Consideration of Fraud in a Financial Statement Audit.*

When evaluating accounting estimates, auditors remain vigilant for indicators that management might be introducing bias into the process. Here are some key areas to scrutinize:

Changes in Estimation Methods:

- *Unexpected Shifts*: Has there been an unexplained change in the methodology used to calculate the estimate compared to the prior period? This could be a red flag.
- *Justification and Past Performance*: If a change did occur, the auditor needs to understand the rationale behind it and assess the accuracy of past estimates made using the previous method.

Appropriateness of Methods and Assumptions:

- *Fitness for Purpose*: Does the chosen estimation method align with the specific requirements of the financial reporting framework? Are the assumptions used realistic and relevant to the estimate?
- *Subjectivity and Consistency*: The level of subjectivity involved in developing assumptions should be considered. Are these assumptions consistent with each other, and do they align with assumptions used elsewhere in the financial statements or the broader business operations?

Addressing Estimation Uncertainty:

- *Alternative Scenarios*: Did management explore alternative assumptions or potential outcomes? How did they justify rejecting these alternatives, and how did they incorporate uncertainty into the final estimate?

Data and External Sources:

- *Data Quality and Accessibility*: Were there significant difficulties in obtaining reliable data, either internally or from external sources used in the estimate?
- *Valuation Disagreements*: Did significant differences in valuation judgments arise between the auditor and management or their valuation expert?

Disclosure Adequacy:

- *Risk Communication*: Do the financial statements adequately disclose the potential effects of material risks and uncertainties, including estimation uncertainty associated with the accounting estimate?
- *Transparency and Reasonableness*: Are the disclosures about estimation uncertainty clear, concise, and sufficiently detailed to provide financial statement users with a comprehensive understanding of the inherent challenges in making this estimate?

By being attentive to these indicators, auditors can identify potential management bias and ensure that the accounting estimates presented in the financial statements are fairly and accurately reflected.

EXAMPLE

An auditor encountered a potentially concerning pattern during an engagement for a company with three significant estimates: workers' compensation claims, self-insured claims, and the allowance for doubtful accounts. In years coinciding with a decline in net income, the auditor observed a consistent trend–all three estimates leaned toward the lower end of the possible range.

This pattern raised red flags regarding potential management bias. Here's why:

- *Income Smoothing*: By consistently lowballing these estimates in times of declining profits, management could be attempting to artificially smooth out earnings and present a more favorable financial picture.
- *Understatement of Reserves and Allowances*: Low estimates for reserves and allowances could lead to an understatement of the company's true liabilities, potentially misleading financial statement users.

To address these concerns, the auditor would likely take the following steps:

- *Perform Trend Analysis*: A more in-depth analysis of historical trends for these estimates will be conducted. This would involve examining not only the absolute values but also factors influencing them, such as claim history, industry benchmarks, and economic conditions.

- *Compare to Industry Averages*: The auditor would likely benchmark the company's estimates against industry averages to see if they fell outside a reasonable range.
- *Discuss with Management*: Open communication is key. The auditor would discuss these observations with management, seeking a clear rationale for the consistently low estimates during periods of declining net income.

Depending on the outcome of these investigations, the auditor might:

- *Accept the Estimates with Additional Procedures*: If the auditor is satisfied with management's explanation and the estimates appear reasonable after further analysis, the estimates might be accepted with some additional audit procedures performed.
- *Modify the Estimates*: If the investigation reveals evidence of intentional understatement, the auditor might need to recommend management adjust the estimates to reflect a more accurate portrayal of the company's liabilities.
- *Report Potential Misstatement*: In extreme cases, if the evidence suggests intentional misstatement to manipulate financial results, the auditor might be obligated to report the issue to relevant authorities.

By taking a proactive approach and investigating these potential red flags, the auditor can help ensure the financial statements accurately represent the company's financial position and avoid being misled by potential management bias.

The auditor will also evaluate whether management has included disclosures, beyond those specifically required by the framework, that are necessary to achieve the fair presentation of the financial statements as a whole. For example, when an accounting estimate is subject to a higher degree of estimation uncertainty, the auditor may determine that additional disclosures are necessary to achieve fair presentation. If management does not include such additional disclosures, the auditor may conclude that the financial statements are materially misstated. If this occurs, then a modification of the opinion may be necessary.

Communication with Governance, Management, or Other Parties

The auditor is required to communicate with those charged with governance or management the qualitative aspects of the entity's accounting policies as well as significant deficiencies or material weaknesses in internal control. The auditor should also consider whether to communicate any matters regarding accounting estimates and related disclosures. There are also times when the auditor may be required to communicate matters with regulators. Appendix B to the standard identifies certain elements that the auditor may want to communicate. Among them are:

- 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.

Documentation

The auditor should include the following in audit 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.

Appendices

SAS 143 contains 2 appendices. Appendix A is a list of inherent risk factors. This appendix provides information about risk factors of estimation uncertainty, subjectivity, and complexity and how they interrelate in the context of creating accounting estimates as well as selecting management's point estimate and related disclosures.

Appendix B discusses communication with those charged with governance and includes the types of matters the auditor might want to communicate.

NOTES

UNIT 4 Risk Assessment

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

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

INTRODUCTION

SAS 145 was issued, like many of the other new standards, to have conformity with the revised risk assessment guidance issued by the International Auditing and Assurance Standards Board. The other major objective of the ASB in issuing the standard was to address concerns that auditors did not adequately understand the current risk assessment guidance. This lack of understanding was noted by peer reviewers who identified issues in understanding the entity's internal control and documenting the risk of material misstatement. The pre-145 guidance did not offer sufficient explanation for many of the concepts that have been more thoroughly defined in SAS 145. SAS 145 clarifies and enhances certain aspects of the identification and assessment of the risks of material misstatement to drive better risk assessments and, therefore, enhance audit quality.

SAS 145 stresses that the auditor should put more effort into their understanding of the entity, its environment and internal control. The existing standard did not include the robust consideration of information technology (IT) that is important in today's IT environment now that auditors obtain a significant amount of audit evidence through data obtained from the entity's financial reporting system and many entities, large and small, are going "paperless." Therefore, evidence may only be in electronic form and testing of controls is required.

To assist the auditor SAS 145 has six appendices.

1. Entity and Its Business Model
2. Inherent Risk Factors

3. Entity's System of Internal Control
4. Entity's Internal Audit Function
5. Information Technology
6. General IT Controls (GITC)

These appendices were created to provide context and examples. The appendix on GITC is especially robust.

Scalability

SAS 145 was written to be scalable taking into consideration that some entities are more complex than others and their level of documentation may vary. Even in situations where the client has less complex processes and systems the standards must be followed and to assist auditors, the guidance identifies opportunities for scalability throughout the sections.

It is important to remember that the concept of scalability is not based on the size of the client but on the nature of the entity and its complexity. When entities are less complex, especially those managed by their owners, the auditor may need to rely less on formal documentation and more on inquiry and observation. The auditor will use professional judgment to determine the nature and extent of the risk assessment procedures to be performed.

EXAMPLE

An auditor's recent engagements with two contrasting clients perfectly illustrate the impact of business models and complexity on risk assessment.

Client 1: The Straightforward Retailer

- **Business:** A private, family-owned retail chain with 20 stores across two states.
- **Revenue:** Over $50 million.
- **Internal Controls:**
  - Centralized financial activities despite the number of stores.
  - Off-the-shelf general ledger system with limited customization options.
  - Manual processes for inventory ordering and vendor payments.
  - Minimal cash transactions–primarily credit cards.
  - Weekly on-site cash reviews by state supervisors.
  - Quarterly physical inventory counts.
  - Limited formal written policies and procedures.
  - Low employee turnover due to positive company culture.

This client's relatively simple business model and centralized controls suggest a lower inherent risk for the audit. While the lack of a sophisticated accounting system and limited documentation warrant some additional procedures, the overall risk assessment is likely to be less complex.

Client 2: The Complex Foundation

- **Business**: A nonprofit foundation raising funds and awarding grants to other nonprofits.
- **Revenue:** $10 million.

- **Financial Instruments Held**:
  - Perpetual trusts
  - Charitable remainder trusts
  - Charitable lead trusts
  - Donor-advised funds
  - Derivatives and alternative investments
- **Investment Management**:
  - Marketable securities managed by four external money managers.
  - More complex investments managed internally.
- **Financial Statements**: Reliant on numerous estimates for investments, liabilities, and donor/beneficiary obligations.

Despite having a lower revenue figure compared to the retailer, the foundation presents a significantly more intricate risk profile. The diverse investment portfolio, including complex instruments and internal management of some investments, introduces inherent risks related to valuation and fair market estimation. Additionally, the nature of the foundation's activities necessitates careful consideration of estimates for liabilities and obligations to donors and beneficiaries.

As demonstrated by these two client scenarios, the auditor's risk assessment procedures will naturally differ based on the inherent complexities of each business. While the retail chain may require a less extensive and detailed risk assessment, the foundation's multifaceted operations necessitate a more comprehensive and rigorous approach to identify and evaluate potential misstatement risks.

PERFORMING THE RISK ASSESSMENT

In order to properly understand the clarifications and changes to the risk assessment process, it is important to define interrelated terms. These definitions conform to international standards. The terms are defined below and are more thoroughly explained in context throughout this unit.

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.

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. Both of the following factors should be present:

- Likelihood—there is a reasonable possibility that the misstatement could occur
- Magnitude—there is a reasonable possibility that the risk is material.

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.

EXAMPLES

Auditor evaluates Property Plant and Equipment

An auditor of an independent school was evaluating the property, plant and equipment and depreciation accounts to determine if they were significant. To be significant there must be a relevant assertion, so the auditor made the following assessment (specific to this client).

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. **Assessment:** Not reasonably possible	Assessment: Not reasonably possible that the balance would be materially misstated. Not a relevant assertion.
Completeness	Likelihood that the asset listing is not complete- when property is purchased it 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. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the balance could be materially misstated. Not a relevant assertion.
Valuation	Likelihood 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. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the balance could be materially misstated. Not a relevant assertion.
Rights and obligations	Likelihood 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. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the balance could be materially misstated. Not a relevant assertion.

Assertion	Likelihood	Magnitude
Cutoff	Likelihood that the depreciation is not recorded in the proper period. This is a routine entry. Likelihood 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. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the balance would be materially misstated. Not a relevant assertion.
Accuracy	Very few purchases or write offs. Depreciation is a routine entry. **Assessment: Not reasonably possible**	**Assessment:** 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. **Assessment: Not reasonably possible**	**Assessment:** 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. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the disclosures would be materially misleading, omitted or misstated. Not a relevant assertion.

The auditor concluded that there were no relevant assertions. Therefore, the property balance was not considered significant, and a risk assessment was not deemed necessary. The auditor performed basic procedures, tying out the account balance to detail and evaluating it analytically.

Auditor Evaluates Accounts Payable

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. **Assessment: Not reasonably possible**	Assessment: Not reasonably possible that the balance could be materially misstated.
Completeness	Likelihood that the AP listing may be missing some items. **Assessment: Reasonably possible**	**Assessment:** Reasonably possible that the balance could be materially misstated. Relevant assertion
Valuation	Likelihood 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. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the balance would be materially misstated. Not a relevant assertion.

Assertion	Likelihood	Magnitude
Rights and obligations	Likelihood 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. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the balance could be materially misstated. Not a relevant assertion.
Cutoff	Likelihood that the AP listing may be contain items that should have been recorded in a different period. **Assessment: Reasonably possible**	**Assessment:** Reasonably possible that the balance could be materially misstated. Relevant assertion.
Accuracy	With the volume of activity running through accounts payable it is reasonably possible that invoice information could be misposted. **Assessment: Reasonably possible**	**Assessment:** remote possibility that the balance would be materially misstated. Not a relevant assertion.
Classification	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. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the balance could be materially misstated. Not a relevant assertion.
Presentation and Disclosure	Presentation and disclosure of accounts payable is not complex. **Assessment: Not reasonably possible**	**Assessment:** not reasonably possible that the disclosures would be materially misleading, omitted or misstated.

Since there are relevant assertions, the auditor would perform a risk assessment on this account balance even though the amount of the balance itself may not be material in a given year. The auditor would generally perform a search for unrecorded liabilities and review the open invoice file.

AU-C 200 states that audit risk is a function of the risk of material misstatement plus detection risk. The risk of material misstatement is comprised of inherent risk and control risk. The risk of material misstatement is found at the:

Financial statement level- The risk is broad and pervasive, potentially affecting several account balances, classes of transactions and assertions. The auditor attempts to take the risk down to the account balance and assertion level but that is not always possible. Examples of overall financial risk could be a lack of competent employs in the accounting area or the auditor's experience that there are too few people to segregate duties. It could be a lax control environment giving rise to the risk of fraud that is not targeted to any one area. These are pervasive risks that are addressed by using more experienced personnel, closer review by experienced personnel and very little, if any, interim testing.

The auditor is **no longer** required to assess whether overall financial statement risks are significant risks.

Risk at the account balance and the assertion level. The 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. The definition of significant account balances is now one with a relevant assertion.

Both overall financial risk and risk at the account balance/class of transaction and assertion level are important to understand in the risk assessment process. 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 since the objective of the auditor is to obtain reasonable assurance that the financial statements are free from material misstatement whether due to fraud or error.

Understanding the Entity and Its Environment

The auditor is still required to understand aspects of the entity and its environment, specifically:

- 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.

The revisions to the existing standard **enhance and emphasize** the auditor's professional skepticism and:

- Clarifies that an appropriate understanding of the entity and its environment, and the applicable financial reporting framework, provides a foundation for being able to maintain professional skepticism throughout the audit
- 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. This is not only technological but also the increasingly complex nature of, the economic and regulatory aspects of the markets that entities operate in today.

SAS 145 considers the entity and the auditor's ability to use automated tools and techniques when performing risk assessment procedures. The standard highlights the importance of understanding the entity's financial reporting system and 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.

In addition, the auditor is required to 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. This is discussed later in the unit.

Analytical Procedures

The auditor performs analytical procedures as risk assessment procedures to help identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that indicate matters that may have audit implications. When unusual or unexpected relationships are identified this may mean that there is a risk of material misstatement. The issue may be one of 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. The other types of analytical procedures are addressed in AU-C section 520. 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.

Understanding and Testing Journal Entries

The level of work to be performed in understanding and testing journal entries was also clarified. The standard does **not require** the auditor to understand the process and controls over **all** journal entries and other adjustments. Just like the extant standard, the auditor should understand the process surrounding the financial statement closing process including examining material journal entries and other adjustments. The 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.

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. Specifically, data supports that 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

Based on AICPA's outreach efforts and results of inspections the ASB found that some of the terminology in the area of understanding internal control was confusing to auditors and the requirements were not clear.

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.

The standard modifies two definitions that the AICPA believes will help auditors to understand the rationale behind understanding internal control.

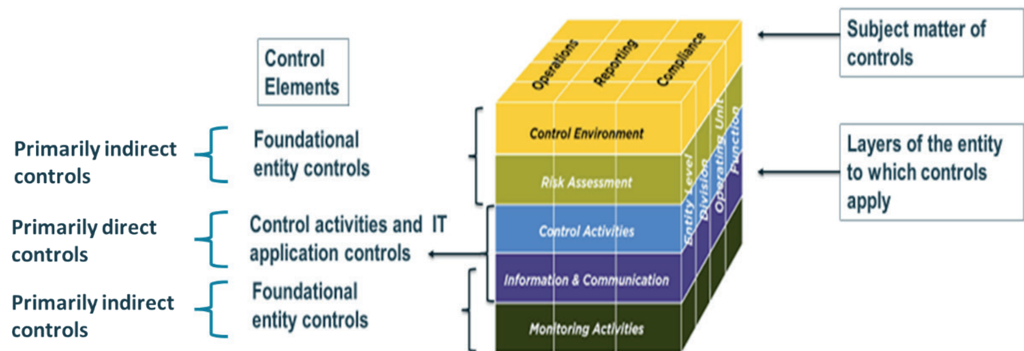
Internal controls—This term has been changed to *system of internal control.* The definition was updated to reflect that it reflects five interrelated components and all are important to the auditor's understanding of the system of internal control.

Controls—Controls are 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. Within this context, policies are statements of what should, or should not, be done within the entity to effect internal control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions. Procedures are actions to implement policies.

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.

New Terminology Related to Internal Control

The requirements are more robust for the 3 components referred to as indirect controls (control environment, risk assessment, and monitoring of internal control), and more robust for the auditor's required understanding of internal controls related to information technology, including general information technology controls.



The figure above illustrates the changes in terminology in SAS 145. The cube, which should already be familiar to auditors is the COSO cube. It identifies the 5 elements of internal control. The subject matter of the controls shows that controls are not limited to reporting but are important for operations and compliance. Auditors focus on financial reporting and to a lesser extent compliance in certain circumstances. The side of the cube illustrates that internal

controls relate to the entity as a whole as well as divisions, operating levels, and production. SAS 145 does not use the terms entity controls. Instead it refers to them as primarily indirect (supporting an account balance/class of transaction and assertion). Direct controls are directly responsive to account balances, classes of transactions and assertions.

Understanding Internal Control That Are Primarily Indirect

The chart below discusses the required level of understanding for the levels of internal control that are primarily indirect.

Level of Internal Control	**Understanding Required—SAS 145**
Control Environment	The auditor should obtain an understanding of the control environment relevant to the preparation of the financial statements. In this the auditor will understand: ■ 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. ■ The oversight of the entity's system of internal control by, those charged with governance when those charged with governance are separate from management ■ Entity's assignment of authority and responsibility ■ How the entity attracts, develops, and retains competent individuals ■ How the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control ■ Deficiencies in the control environment undermine the other components of the entity's system of internal control.
Risk Assessment	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: ■ identifying business risks, including the potential for fraud, relevant to financial reporting objectives ■ assessing the significance of those risks, including the likelihood of their occurrence 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. 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.

Level of Internal Control	Understanding Required—SAS 145
Monitoring	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 ■ Could include ongoing as well as separate evaluations for monitoring the effectiveness of controls, identification of deficiencies and implementing corrective action. Should the entity have an internal audit function, the auditor will understand its nature, responsibilities and activities. 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. The auditor will 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.
Information and Communication	Evaluate aspects of the information and communication components. The 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 ■ communication of significant matters Auditor is **not** required to evaluate the design or determine implementation of individual controls in this component. The individual identification of controls is focused on information processing controls referred to as transaction controls.

More Robust Understanding of Information Technology

The section of the standard on Information Technology controls is very robust highlighting that understanding the entity's information technology (IT) and general IT controls (GITC) is an important part of SAS 145. It is so important that the ASB included appendices specifically on technology and one on GITC.

The entity's information 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 addressing the risks of material misstatement.

EMPHASIS!! Prior to SAS 145, auditors primarily focused on understanding controls for high-value financial systems like those processing revenue, receivables, payables, expenses, and payroll. However, SAS 145 necessitates a more comprehensive approach to the IT environment. Auditors must now delve deeper to understand the nature and complexity of all IT applications used, including any customizations. They must also assess the supporting IT infrastructure, considering whether it's internally managed, outsourced, or a combination of both. This includes data warehouses, report writers, and interfaces that connect various systems. Furthermore, the presence of emerging technologies requires consideration of the potential risks associated with them. This heightened focus on IT stems from the recognition that transactions no longer flow exclusively through traditional financial modules but rather navigate a complex network of systems. While SAS 145 doesn't demand the same in-depth examination for every system as before, it emphasizes the importance of understanding the entire information processing ecosystem. By mapping transaction flows and scrutinizing how IT systems influence account balances and disclosures, auditors gain a holistic perspective that empowers them to effectively assess controls across significant areas, ultimately leading to a more robust and risk-focused audit approach in the digital age.

GITC do not need to be identified for each of the entity's various IT processes. GITC are by nature, supportive of many different applications. It is important to obtain an understanding of those that are mitigate the risks of material misstatement.

The chart below illustrates the characteristics that may give rise to risks from the use of IT. The chart could be used by an auditor to identify the depth of understanding of GITC required for a specific client situation.

Characteristics that are less likely to give rise to IT Risk	**Characteristics that are more likely to give rise to IT Risk**
■ Stand-alone applications ■ Volume of data is not significant ■ Application's functionality is not complex ■ Each transaction is supported by hard copy documentation ■ Management does not rely on automated controls ■ Management does not rely on the system to produce complete and accurate reports-manual reconciliations are performed ■ Auditor intends to directly test information produced by the entity as audited evidence	■ Applications are interfaced ■ Volume of transactions is significant ■ Functionality is complex because of automatic initiation and processing of transactions ■ Complex calculations are made by IT ■ Management relies on the application to perform automated controls

Understanding Control Activities

The SAS is very specific in what the auditor is required to understand as it relates to control activities and specifically notes that the 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

The internal controls over these areas are defined as **identified controls**.

The fact that the auditor is only required to understand evaluate the design and implementation for account balances, classes of transactions and disclosures that are **significant risks** eliminates the volume-based method used primarily by auditors today and as discussed above makes the auditor's understanding of the flow of transactions along with other characteristics of the financial reporting system even more important.

When assessing a risk to determine if it is significant, the 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. As noted earlier in the section on definitions, this means those risks that are higher on the spectrum of inherent risk.

The guidance in SAS 145 is affected by other standards. AU-C 320, *Materiality,* states that materiality and audit risk are considered when identifying and assessing the risks of material misstatement. It is understood that that the 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.

As it relates to SAS 145, 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.

Since only account balances and classes of transactions with relevant assertions that are determined to be at the higher end of the spectrum of inherent risk are considered significant risks, this eliminates the need to identify controls responsive to other risks and understand them. However, the auditor may determine that these areas fall into the "other control" category and obtain an understanding over them anyway.

Additionally, the fact that the auditor is required, in the information and communication element, to obtain an understanding of procedures used to initiate, authorize, record, process, and report information in the financial statements whether automated or manual, this will result in the auditor evaluating portions of the system that process a material volume of transactions even if they are not identified as significant risks.

Lack of Segregation of Duties

Many auditors have clients that lack of segregation of duties. This may be a targeted risk over a specific part of the financial reporting system or may be pervasive. Either way, when an entity has this issue, the auditor may be more likely to conclude that the risk of material misstatement for certain account balances and classes of transactions is likely to be reasonably possible, thereby causing them to be included in the risk assessment process and possibly be considered in the "other control" category.

Understanding the Design and Implementation for Identified Controls

SAS 145 refers to the controls for which the auditor is required to evaluate design and determine implementation. Other terms for identified controls are relevant controls or key controls. Identified controls also include those GITC (general IT controls) that address risks arising from the use of IT.

When evaluating the design of an **identified** control the auditor considers whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. An ineffectively designed control will not, by definition, achieve the control objective. An improperly designed control may represent a control deficiency.

The auditor determines whether the identified control has been implemented by determining that the control exists, and that the entity is using it. The auditor performs a combination of the following procedures to assess the design and implementation.

- inquiry of entity personnel
- observing the performance of specific controls
- inspecting documents and reports
- reperforming the specific controls.

A **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. Walk-throughs are used to assist the auditor in understanding the information system discussed above, evaluating the design of controls that address the risks of material misstatement, and determining whether those controls have been implemented. A walk-through is usually sufficient to evaluate design and determine implementation.

Inquiry is an important part of performing a walk-through. The auditor needs to determine that entity personnel understand the entity's prescribed procedures and controls particularly for the application of manual controls. These inquiries, combined with the other walk-through procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Inquiry **alone** is not sufficient to determine whether a control has been implemented.

Control Risk

Once the auditor understands the identified controls, they can decide if it is either necessary or desirable to test them. If controls are tested, then the auditor determines if the evidence from the test is sufficient to state that they are reliable. The auditor uses that basis to assess control risk. If controls are not tested, then risk is assessed at high.

Team Discussion

The auditor will hold a team discussion during the planning stage of the audit that allows the engagement team members to exchange information about the business risks to which the entity is subject, how inherent risk factors may affect the susceptibility of classes of transactions, account balances, and disclosures to misstatement, and about 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, including how fraud may occur.

Team members benefit by the discussion because they can communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks. The risk assessment is generally a byproduct of this discussion.

Assessment of Inherent Risk and Control Risk

SAS 145 requires the assessment of inherent risk and control risk to be performed separately. The AICPA has stressed this concept for years and the standard now codifies the requirement. It makes sense intuitively because inherent risk relates to characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, **before** consideration of controls. In evaluating inherent risk the auditor considers complexity, subjectivity, change, uncertainty, and susceptibility to misstatement due to management bias or other fraud risk factors. As noted in the definition of inherent risk, the auditor's evaluation of inherent risks is **before** considering controls. When the auditor assesses control risk the auditor determines whether controls are effective throughout the period. When controls are not tested, control risk must be assessed as high.

The auditor is required to assess risk where there are **relevant assertions**. The definition, discussed above centers on the reasonable possibility that the account balance/class of

transaction could have a material misstatement due to the assertion. There can be more than one relevant assertion in an account balance/class of transaction.

Since only relevant assertions are assessed for risk, it follows that risk of material misstatement is made at the assertion level as well. Previously, some auditors assessed the risk of material misstatement for inherent and control risk together for an entire account balance or class of transaction.

Inherent Risk

To assist auditors in their understanding of inherent risk the ASB introduced a new term in SAS 145, ***inherent risk factors***. Inherent risk factors are defined as characteristics that affect susceptibility to misstatement of an assertion about a class of transactions, account balance, or disclosure, and that may be quantitative or qualitative in nature.

The auditor uses the inherent risk factors to evaluate certain aspects of events or conditions that affect an assertion's susceptibility to misstatement. SAS 145 also introduces the concept of the ***spectrum of inherent risk***. The spectrum refers to the fact that 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. Inherent risk varies along the spectrum. This term was introduced in order to try to drive consistency in the auditor's risks assessment process and to provide a framework for considering the likelihood and magnitude of possible misstatements.

Examples of inherent risk factors are subjectivity, complexity, change, uncertainty, and susceptibility to misstatement due to management bias or fraud. The chart below describes where inherent risk factors are related to the preparation of financial information.

Inherent Risk Factor	Definition	Example
Complexity	Relates either to the nature of the information or in the way that the required information is prepared. This is especially true when the preparation process is more inherently difficult to apply.	Management has a complex rebate system for its products. The rebate formula includes different levels for different purchase levels and different terms for different customers. In addition, the entity has thousands of commercial customers.
Subjectivity	Arises from inherent limitations in the ability to prepare required information in an objective manner. This may be due to limitations in the availability of knowledge or information resulting in management making subjective judgments about the appropriate approach to take as well as the information to include in the financial statements.	Revenue recognition for the hospital system involves a degree of uncertainty as it relates to variable consideration. The hospital has contracts with Medicare that include a fixed payment component and a "bonus" for meeting or exceeding certain quality indicators. The contracts span 3 years resulting in management not only making an estimate of the level of quality at the end of a reporting period but adjusting prior periods either up or down based on the assessed quality. Management's evaluation of the estimate each year involves significant subjectivity.

Inherent Risk Factor	Definition	Example
Change	Results from events or conditions that, over time, affect the entity's business or the economic, accounting, regulatory, industry, or other aspects of the environment in which it operates, when the effects of those events or conditions are reflected in the required information. These events or conditions may occur during, or between, financial reporting periods.	Recent changes in professional literature, most notably the revenue recognition, lease and current expected credit loss standards may result in changes in the way that management accounts for those transactions. Changes in management's selection of accounting policies, how accounting estimates are made and management's assumptions are likely to be affected.
Uncertainty	Occurs when the relevant information cannot be prepared based only on precise and comprehensive data that is verifiable through direct observation. Management may need to take an approach that applies the available knowledge and make reasonable assumptions. Constraints on the availability of knowledge or data, which are not within the control of management are sources of uncertainty, and their effect on the preparation of the required information cannot be eliminated.	Management needed to estimate the amount of the current expected credit loss (CECL) on notes receivable on self-financed product purchases. CECL takes into consideration the expected losses over the life of the loans, which for this entity were typically 5 years. Unlike the incurred loss model the CECL model takes into consideration the projection of possible future events. This adds a significant amount of estimation uncertainty.
Susceptibility to fraud or management bias	Susceptibility to management bias results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. This can result from incentives or pressures such as a perceived need on the part of management to achieve a desired result. Lack of or weak internal controls, such as failure to have an estimate reviewed by another party, often provide management with the opportunity resulting in bias that may remain undetected.	Management was concerned that the company would not meet its debt covenants for the period. Failure to meet the covenants could result in the debt becoming current. The entity had several reserves that were subject to high estimation uncertainty. Since the CFO created the estimate with no oversight or review the auditor was concerned about the possibility of management bias.

Other inherent risk factors arise from events or conditions related to the entity such regulatory factors, issues related to the complexity of the business model, the financial reporting framework, economic conditions, pending litigation, transactions with related parties, fraud risk factors and contingent liabilities.

Significant Risk

Inherent risk factors are used to identify areas of risk so the auditor can identify the relevant assertions for account balances and classes of transactions and classify the inherent risk as high, moderate, or low. Then the auditor will determine if the risk is a significant risk.

A significant risk transcends the realm of a typical error. It represents a confluence of two critical factors. The first pertains to the inherent risk associated with an account or financial assertion. This inherent risk signifies the intrinsic susceptibility of the area to material misstatement, absent any mitigating controls. A high inherent risk assessment suggests a

heightened potential for irregularities or errors to occur. Essentially, it exposes an inherent vulnerability within a specific section of the financial statements.

The second factor contributing to a significant risk is the magnitude of the potential misstatement. Here, the focus shifts to the potential size or impact of an error, should it materialize. A significant risk typically entails the possibility of a large or impactful misstatement that could have severe consequences for the financial statements' credibility.

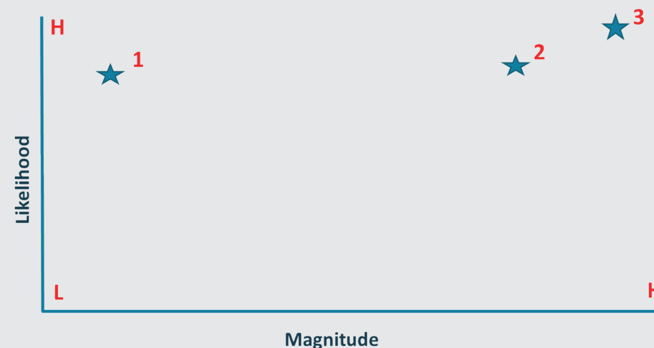
However, the classification of significant risks extends beyond inherent risk alone. Certain risks, by their very nature, are automatically deemed significant as outlined in specific sections of AU-Cs. These pre-designated high-risk areas include:

- *Management Override*: This risk acknowledges the potential for management to intentionally manipulate the financial statements to achieve predetermined objectives.
- *Fraud Associated with Revenue Recognition*: This highlights the possibility of fraudulent activities specifically related to how revenue is recognized within the financial statements.
- *Unusual Transactions with Related Parties*: This addresses the risk associated with transactions involving entities related to the company (e.g., owners, affiliates) that deviate from normal business practices and could potentially be used for improper purposes.

By comprehensively considering both inherent risk and the potential magnitude of misstatement, along with these pre-designated significant risk areas, auditors are empowered to effectively identify and address the most critical areas susceptible to material misstatement during an audit. This targeted approach fosters a more efficient and risk-focused audit methodology.

EXAMPLE

Illustration of the Spectrum of Inherent Risk



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.

2. **Account balance and assertion: Accounts receivable, valuation**
   - The client's accounts receivable balance is material to the financial statements. During the year under audit, the pandemic has caused some of its customers to fail to make the required payments on time and the aging has deteriorated. In addition, the client is implementing the current expected credit loss standard.

- The client has a theory 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 use 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**

3. **Account balance: Warranty reserve, valuation**
   - 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**

Performing Substantive Procedures

AU-C 330 was modified by SAS 145. The revised guidance states that the auditor is not required to perform substantive procedures for account balances/classes of transactions that are not significant. Generally, the auditor will perform limited procedures which may consist of tying out balances to detail, performing analytical procedures or making a computation to adjust the balance (such as in the case of prepaid expenses) so that it is appropriate. This is a change to AU-C 330 where previously if the account balances were material procedures were performed.

Stand Back Requirement

As discussed earlier, materiality is no longer the specific determinant of whether an account balance or class of transaction is deemed to be significant. At the end of the risk assessment process the auditor will look back at account balances, classes of transactions and disclosures that are not significant but are material. The auditor will consider whether the auditor's determination of relevant assertions, and therefore significance of the account balance or class of transaction, remains appropriate.

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.

RISK-BASED APPROACH FOR GROUP AUDITS

The ASB issued SAS No. 149, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)," in March 2023. This new standard significantly impacts how auditors approach group audits.

One of the most crucial changes introduced by SAS No. 149 is the shift toward a risk-based approach. Previously, auditors were required to identify "significant components" for focused audit work. SAS No. 149 empowers the group engagement team to leverage professional judgment, basing their procedures on assessed risks within each component. This aligns the standard with recent ASB pronouncements and fosters a more flexible and efficient audit approach.

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.

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.

SAS No. 149 becomes effective for audits of group financial statements for periods ending on or after December 15, 2026. This provides ample time for auditors and employee benefit plan sponsors to adapt their procedures to comply with this new standard.

NOTES

UNIT 5

Quality in an Audit Engagement

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- 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, QUALITY MANAGEMENT FOR AN ENGAGEMENT CONDUCTED IN ACCORDANCE WITH GAAS

SAS 146 amends AU-C 220, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*. The standard, which applies only to audit engagements, ties in the role of engagement quality to the system of quality management described in SQMS-1. It also reiterates aspects of SQMS-2 related to the relationship between the engagement partner and the engagement quality reviewer.

The 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 and procedures related to engagement quality
- determining whether to design and implement responses at the engagement level over and above those in the firm's policies or procedures
- communicating information related to the audit engagement that is required by the firm's policies or procedures in support of the firm's quality management system.

SAS 146 clarifies that the engagement partner may assign certain tasks to others within the engagement team. However, the partner should be appropriately involved throughout the engagement as this is fundamental to providing the engagement leadership that results in high quality audits. Since the standard is scalable it clarifies that if the partner is working alone on

the engagement, certain requirements cannot be followed since they involve team members. However, if there are multiple team members the requirements should be followed.

Terminology

SAS 146 includes important responsibilities relative to the partner's role. The phrase "take responsibility for . . ." is used for requirements where the engagement partner is permitted to assign the certain activities to experienced team members. When the requirements specify that the engagement partner **should** do something the SAS intends for the partner to conduct the activity. Other team members may supply information to the partner, but the task remains with the partner.

> **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.

Partner Responsibilities

The following requirements of the engagement partner were added to the SAS to reinforce this point.

Fulfilling leadership responsibilities, including taking actions to create an environment for the engagement that emphasizes the firm's culture and the expected behavior of engagement team members, and assigning procedures, tasks, or actions to other members of the engagement team.

Understand the relevant ethical requirements, including those related to independence, that are applicable to the audit engagement and assume responsibility related to ethical requirements, ensuring that team members are aware of them, including the firm's related policies or procedures. The partner should identify, evaluate and address:

- Threats to compliance with relevant ethical requirements, including those related to independence
- Circumstances that may cause a breach of relevant ethical requirements, including those related to independence, and the responsibilities of members of the engagement team when they become aware of breaches
- Responsibilities of members of the engagement team when they become aware of an instance of noncompliance with laws and regulations by the entity
- The partner should determine whether relevant 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. This information should be used when performing the audit engagement. If

the team becomes aware of information that could have caused the partner to make a different judgment on acceptance or continuance it should be communicated to the firm so that the firm and engagement partner can take the appropriate measures.

Engagement Resources. The partner should ensure that the engagement is appropriately staffed and that people on the engagement whether members of the team, external specialists or internal auditors providing direct assistance collectively have the knowledge, competence and capabilities and time to perform the engagement.

Supporting engagement performance, including taking 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 those relating to difficult or contentious matters identified during the audit engagement, and the conclusions reached
- other matters that, in the engagement partner's professional judgment, are relevant to the engagement partner's responsibilities.

If contentious issues arise, the partner is responsible for handling the consultation and implementing any resolution. The same is true for any disagreements among the engagement team members.

On or before the date of the auditor's report, the engagement partner should determine, from their review of audit documentation and discussion with the engagement team, that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. Before dating the report, the partner should review:

- financial statements and auditor's report
- key audit matters along with documentation, if applicable
- formal communications to management and those charged with governance.
- Communications to regulators, if applicable.

Engagement Quality Review

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.

Monitoring and Remediation

The engagement partner should take responsibility for understanding the information provided by the firm's monitoring and remediation process, as communicated by the firm and the network, if applicable. The partner should determine the effect on the audit engagement and take action to remediate where necessary.

Taking Overall Responsibility for Managing and Achieving Quality

SAS 146 contains a "stand-back" requirement to determine whether the engagement partner has taken overall responsibility for managing and achieving quality, including determining that the engagement partner's involvement has been sufficient and appropriate throughout the engagement and that the appropriate judgments have been made considering the nature and circumstances of the engagement. This should occur before dating the report.

Documentation

Documentation for each engagement should meet the requirements set forth in AU-C 230 *Audit Documentation.* It should include:

- Significant issues identified, relevant discussions with personnel, and conclusions reached regarding fulfillment of responsibilities relating to relevant ethical requirements, including those related to independence
- the acceptance and continuance of the client relationship and audit engagement
- nature and scope of, and conclusions resulting from, consultations made during the audit, if applicable, and how the conclusions were implemented
- if the engagement is subject to an engagement quality review, that the engagement quality review has been completed before the release of the auditor's report
- documentation required by other professional standards

NOTES

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Tax	**Information Technology**
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