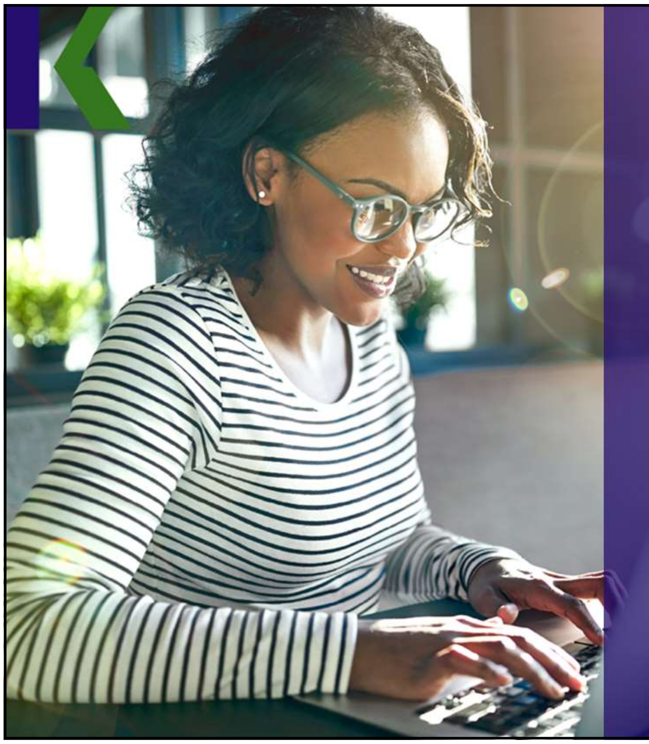


Issues Frequently Noted in Peer Review and Introduction to the AICPA's New Quality Management Standards

NCACPA Mountain Cluster
October 2022

KAPLAN

Contents for Today's Course

- AICPA's EAQ Initiative
- Quality Management
- Audit and Disclosure Issues
- Single Audit Issues
- Employee Benefit Plan Issues
- Accounting and Review Issues

Leaning Objectives

- Identify the components of the AICPA's EAQ Initiative and current workplan
- Distinguish between the peer review ratings and findings
- Identify and implement components of the new Quality Management Standards
- Identify issues noted by peer reviewers and others related to:
  - Auditing and Disclosure
  - Single Audits
  - Employee Benefit Plans
  - Accounting and Review Services
- Implement corrective action where needed in those areas

AICPA's EAQ Initiative

Brief History

- Regulators, investors, other capital markets stakeholders and users of the financial statements need accurate and transparent financial information for decision making.
- AICPA, peer review program, and regulatory agencies play a role in ensuring audit quality.
- Business and regulatory environments have changed since peer review was instituted in 1970s
- Findings by regulators and reviewers suggested that audit quality needed improvement.
- The AICPA instituted its Enhancing Audit Quality (EAQ) Initiative in 2014 to help to improve audit quality.
- AICPA issued white papers, practice aids, and held webinars and other events.

Brief History

- Enhanced requirements for being a peer reviewer
- Oversight by SMEs (Subject Matter Experts)
- Peer review program for firms that perform engagements under SASs, SSARS, SSAEs, GAS, and PCAOB standards
- Great resource- peer review checklists

Engagement Question

The AICPA has been issuing Audit Risk Alerts for over 30 years. Among other things, they focus on deficiencies that have come to light in audits. Why do you believe that audit quality continues to be a problem?

A. The standards are too complicated
B. There is not enough time to meet all the requirements
C. It's not that firms don't perform the procedures, it's a lack of documentation
D. Practice aids are misleading. It looks like all is needed is a check mark and then the peer reviewer wants something else.

Peer Review Function

- Once every three-year event
- In year peer review is performed the firm no requirement for internal inspection
- Engagement review and system review
- System review- evaluate system of quality control for performing accounting and auditing work
- Objective- determine whether the system is designed to ensure conformity with professional standards and whether firm is complying with its system.

Peer Review Function

- Opinion on whether during the year under review the firm's:
  - system of quality control for its accounting and auditing practice has been designed in accordance with quality control standards established by the AICPA
  - quality control policies and procedures were being complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.
- Corrective action (CA) - could result in firm making changes to its system, additional CPE. Report acceptance body (RAB) may require pre- or post-issuance reviews.
- Completed CA is presented to a RAB that may require other follow-ups
- Representations are made by the firm in both an engagement review and a system review

Peer Review Function

- Must select engagements
  - Engagements performed under *Government Auditing Standards;*
  - Audits of employee benefit plans;
  - Audits of depository institutions;
  - Examinations of service organizations (SOC 1 and SOC 2)
- In May 2021 the AICPA announced that audits and the related compliance and exemption engagements for SEC registered broker dealers should no longer be included in the scope of peer review.
- SIPC agreed-upon procedure engagements will remain subject to peer review

Clarified Peer Review Standards

- **Clarified Peer Review Standards are effective May 2022**
  - **Onsite office visits**- the onsite review element was changed from visiting a sufficient number of offices on site to provide reasonable assurance that the QC policies and procedures are adequately communicated to the firm. Now since technology makes it easier to perform the evaluation remotely the reviewer chooses site visits based on risk. In addition, the number of procedures in a system review no longer need to be performed at the reviewed firm's offices.
  - **Choosing surprise engagements**- the guidance was revised to have the reviewer decide whether a surprise engagement is necessary as part of the reviewer's risk assessment procedures. Previously the reviewer would choose one engagement when they came to do the review.
  - **Classification of significant deficiencies**- The term "significant deficiencies" will be eliminated in fail reports on engagement reviews because it created confusion. In existing guidance, the term didn't indicate severity but rather was used to show that a deficiency was present on all engagements reviewed. Under the clarified guidance, fail reports on engagement reviews will identify only "deficiencies."

Clarified Peer Review Standards

- **Changes to Peer Review Standards (con't)**
- **Single Audit engagements**- Guidance refers to the materials related to the engagement profile, supplemental peer review checklist for single audit including the explanation for "no" answers and other comments being provided to the Report Acceptance Body (RAB). Now since the materials for single audits are provided to a technical reviewer who is required to have CPE hours related to single audit engagements as well as a course on performing technical reviews, the review of materials by the RAB is not required. The RAB may still ask for documents if they need them.
- **Review of Quality Control Materials (QCM)** – there is no longer separate guidance on review of QC materials. A QCM provider may choose to have an examination of their materials in accordance with attestation standards.

Engagement Review

- Engagement Review is required when firm only performs:
  - Financial statement preparation engagements under SSARS
  - Compilations of financial statements under SSARS
  - Reviews of financial statements under SSARS
  - Agreed-upon procedures under SSAES
  - Review attestation engagements under SSAES

Engagement Review

- Includes sample of firm's engagements. NO opinion issued. Firm receives rating of pass, pass with deficiencies, or fail. The peer reviewer is not issuing an opinion.
  - Pass rating- the reviewer is saying that nothing came to their attention to lead them to believe the work was not performed and reported on in accordance with relevant standards in all material respects.
  - Pass with deficiencies rating- reviewer has determined that at least one, but not all, of the engagements submitted for review were not performed in accordance with professional standards in all material respects.
  - Fail rating- reviewer notes that all of the engagements submitted for review had deficiencies that resulted in the engagements having not been performed or reported on in conformity with applicable professional standards in all material respects.
  - As with system reviews, the firm is required to make remediations

System Review

- Far more comprehensive than engagement review
- Reviewer chooses engagements for review and also interviews certain firm personnel, obtains representations from the firm, and examines administrative and personnel files.
- Reviewer may find that the system of quality control is not properly designed or that it is properly designed but the firm is not complying with the requirements of the system.
- Engagements that were not performed and/or reported on in conformity with applicable professional standards in all material respects is considered "nonconforming."
- Classification system to distinguish severity of issues noted:
  - Matters, findings, deficiencies, significant deficiencies

Peer Review Classifications

- Matter for further consideration (MFC) - peer reviewer identifies that the firm did not comply with one or more elements on the peer review checklist. Peer reviewer will look at similar findings in the aggregate when deciding as to whether a finding is a deficiency or significant deficiency.
- If the finding does not rise to the level of a deficiency, it is documented on an FFC form. If one or more findings are a deficiency or significant deficiency, a report rating of pass with deficiency or fail would be appropriate.

Peer Review Classification

- **Finding for further consideration (FFC)** - one or more related matters in the firm's system of quality control, or compliance with it, where there is **more than a remote possibility** that the reviewed firm would not perform or report in conformity with applicable professional standards.

Example

A peer reviewer was using audit checklist 20,400 to evaluate an audit engagement in a system review. He read question A503 - "Did the auditor communicate an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified to those charged with governance?" The peer reviewer noted the auditor did not issue a written communication. Since the communications to governance do not have to be in writing, the peer reviewer asked where the auditor documented the communication. Although the auditor stated that the communication was made orally the lack of documentation caused the peer reviewer to conclude that this question should be answered "no" and treated as a matter for further consideration form. It was documented it on an MFC (matter for further consideration) form with other similar documentation issues noted by the peer reviewer.

Peer Review Classification

EXAMPLE

A peer reviewer evaluated 6 audit engagements and 2 review engagements in a system review. Two of the engagements were performed under Generally Accepted Government Auditing Standards (GAGAS). The audit team prepared the financial statements in each of the engagements. However, they did not consider the nonaudit services performed in the aggregate as a threat to independence in either of them. Nor was the appropriate language about management taking responsibility for the oversight of the services and designating someone with the appropriate skills to oversee the services in the engagement letter or representation letters.

In addition, since they did not consider independence related to nonaudit service, the team did not consider the skills, knowledge or experience of client personnel designated to oversee the service. In the two engagements under GAGAS the preparation of financial statements was not considered to be a significant threat with safeguards applied.

Based on discussions with the engagement team it was apparent that there was confusion among the teams as to the level of work that should be performed and documented for independence. The team thought by documenting the annual signoffs that the auditors were independent of their clients that this was sufficient. There were no issues noted with the reviews or the GAAS engagements.

Because this issue concerned GAS engagements the MFC would result in non-conforming engagements and could go to the peer review report as a deficiency. Note that If the engagements were only performed under GAAS then the matter could go to an FFC because it would not result in nonconforming engagements.

Peer Review Classification

- **Deficiency** - due to the nature or systemic causes that the firm would not have reasonable assurance of performing or reporting in conformity with applicable professional standards in **one or more important respects**.
- Distinction between a deficiency and a significant deficiency is that the peer reviewer has concluded that except for the deficiency the firm has reasonable assurance of performing and reporting in conformity with professional standards. This will lead to a report level of "pass with deficiencies."
- A **significant deficiency** -the reviewed firm's system of quality control taken as a whole, does not provide the reviewed firm with reasonable assurance of performing or reporting in conformity with applicable professional standards in all material respects.
- A significant deficiency leads to a report rating of "fail."

Peer Review Classification

- If a deficiency or significant deficiency is related to an engagement in a "must select" area or specific industry, the report will identify the area.
- Generally, since the System Review is designed to report on the firm's system of quality control, the report would not necessarily describe every engagement that was deemed nonconforming.

Peer Review Ratings

- **Pass** -- The system is appropriately designed, and the firm complies with the system in all material respects.
- **Pass with deficiencies** -- The system is designed, and the firm complies with the system in all material respects, except for certain areas that are explained in the peer review report.
- **Fail** -- The peer reviewer has concluded that the firm's system is not suitably designed, or the firm does not comply with the system as outlined in the report.
  - Firm is required to take corrective action and remediate engagement deficiencies and weaknesses identified in its system of quality control.
  - Peer reviewer will evaluate the response to see if it is an indication of further issues in the quality control system and whether monitoring procedures are deemed necessary.
  - Since peer review is required by state accounting licensure boards, firms that pass with deficiencies or fail are required remediate their deficiencies.
  - Firms that fail remediation may have their license revoked.

Peer Review Progress

- Peer review progress report issued April 2022.

System Reviews	2019-2021	2018-2020
Pass	82%	79%
Pass with deficiencies	12%	14%
Fail	6%	7%
Subtotal	100%	100%
Engagement Reviews	**2019-2021**	**2018-2020**
Pass	82%	79%
Pass with deficiencies	11%	11%
Fail	7%	10%
Subtotal	100%	100%

Total System and Engagement Reviews	2019	2020	2021
Nonconforming	10%	16%	14%
Total Audits			
Nonconforming	15%	26%	27%

Peer Review Progress

- Peer review progress report issued April 2022.

	2019	2020	2021
Number of remedial actions- total	5,885	4,024	4,291
CPE	50.5%	56.6%	59.7%
Pre issuance review	10.9%	9.0%	8.2%
Post issuance review	13.9%	11.6%	12.2%

- Statistics show that 77% of firms improved after CPE, 86% improved after third party review of engagements of QC documents. 90% improved after pre-issuance reviews.
- If firms fail to remediate after their second consecutive non-pass peer review they can be terminated from the peer review program.

AICPA Focus for 2022

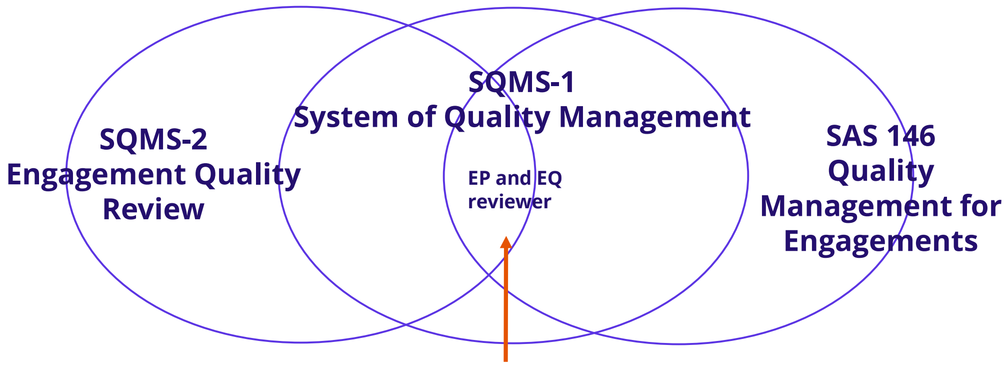
- Top issues identified for focus in 2022 were **risk assessment and single audit**.
- Pervasive area -**documentation**
- Peer Review Enhanced Oversights showed that 25% of engagements subject to review were materially nonconforming due to failure to comply with documentation standards.
- **Risk Assessment-** Firms will have access to practice support in risk assessment and response, with a focus on SAS 145 awareness and interpretation (effective CYE 2023)
  - Navigating heightened fraud risk in current environment
- Single audit remains focus. Significant federal funds for NFP, governments and for profit entities. Some never had a single audit before.
- 2021 infrastructure law will lead to more federal dollars subject to single audit in 2023.

AICPA Focus for 2022

- **Advocacy work supporting auditors and auditees-** The AICPA will continue its advocacy work and focus on supporting auditors with the resources they need to perform high quality work, as well as raise awareness with auditees about the importance of selecting a qualified auditor.
- **New standards coming online-** SAS 142, Audit Evidence is effective for calendar year ends 2022. In 2021, failures relative to accounting estimates were the most common engagement-level deficiencies.
- **Leases-** ASU 2016-02, Leases will be effective for nonpublic entities for calendar year ends 2022. This standard will require a major accounting change which requires critical accounting estimates.
- **Attestation Engagements**- In response to stakeholder demands and potential regulatory requirements, entities are increasingly reporting on their environmental, social and governance performance in addition to financial reporting measures.

Quality Management

QM Standards- Introduction



Relationship between EQ reviewer and audit partner addressed in SAS 146

Issued in 2022

SQMS 2 and SAS 146 highlight the importance of those components in the Firm's System of Quality Management

QM Standards- Introduction

- Standards were issued, in large part, to converge with the IAASB's new suite of standards.
- AICPA also wanted to address:
  - Risk in audits, reviews and attestation engagements which is correlated with partners who perform a low volume of these engagements
  - Lack of focus on planning
  - Overreliance on practice aids and quality management materials from third party vendors
  - Challenges experienced by smaller firms in applying the standards
  - Need to improve firm governance and leadership as well as the culture and tone from the top of the firm

QM Standards- Introduction

Standard	Effective Date
SQMS 1 -System of Quality Management	Systems of quality management are required to be designed and implemented by December 15, 2025, and the evaluation of the system of quality management is required to be performed within one year following December 15, 2025.
SQMS 2- Engagement Quality Reviews (EQR)	Audits or reviews of financial statements for periods beginning on or after December 15, 2025, and Other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2025. An engagement in the firm's accounting and auditing practice begins when an engagement letter or other agreement to perform attest services is signed, or when the firm begins to perform the engagement, whichever is earlier.
SAS 146- Quality Management for an Engagement Conducted in Accordance with GAAS	Engagements conducted in accordance with generally accepted auditing standards for periods beginning on or after December 15, 2025

SQMS 1- System of Quality Management

- The system of quality management is designed to meet two objectives.
  - The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements and conduct engagements in accordance with such standards and requirements.
  - Engagement reports issued by the firm are appropriate in the circumstances
- Firm is responsible for its own quality management even when it belongs to a network of firms, and the firm complies with network requirements or uses network services

SQMS 1- System of Quality Management - Components

1. The firm's risk assessment process (new)
2. Governance and leadership (adapted from the leadership (QC 10)
3. Relevant ethical requirements (same name in QC section 10)
4. Acceptance and continuance of client relationships (same name QC section 10)
5. Engagement performance (same name as component in QC section 10)
6. Resources (adapted from the human resources component in QC section 10)
7. Information and communication (new)
8. The monitoring and remediation process (adapted from monitoring in QC 10)

Component 1: Risk assessment process

- **Step 1:** Firm leadership should assume responsibility for the establishment of quality objectives
- **Step 2:** Identify and assess risks to the achievement of the objectives (quality risks).
  - Consider the factors that have a reasonable possibility of adversely affecting the achievement of quality objectives
  - How the risks arise, how often they are likely to occur
  - How long it would take to have an impact on the system

Component 1: Risk assessment process

Understand the factors (conditions, events, circumstances, actions of inactions) that many adversely affect the achievement of quality objectives. Assess the issue and prepare a plan to respond to the risk.

Risk: Challenge in retaining qualified staff due to the market

Staff leaving the firm causes more work for remaining people.

Difficulty in finding experienced hires. Newer people have fewer knowledge, skills and experience.

Likelihood: High
Magnitude:
Moderate to high: depending on the level (seniors being the highest).

Risk Response Plan

1. Challenge all proposal opportunities for firm's ability to appropriately staff.
2. More partner involvement in engagements where there is more inexperienced staff perform the work and managers do more direct review.

Component 1: Risk assessment process

- Individual (s) assigned ultimate responsibility and accountability for the system must evaluate and conclude whether it provides the firm with reasonable assurance that the objectives were met (annual)
- The firm is required to include the following responses in its system of QM
  - identify, evaluate, and address threats to compliance with ethical requirements.
  - identify, communicate, evaluate, and report any breaches of ethical requirements and respond to the causes and consequences of the breaches in a timely manner.
  - Obtain confirmation of compliance with independence requirements from all personnel required by to be independent (annual).
  - Adopt policies for receiving, investigating, and resolving complaints/allegations about failures to perform work in accordance with professional standards, legal and regulatory requirements or noncompliance with the firm's policies

Engagement Question

Which of the following is **not** a consideration point when assessing risk related to the system of quality management?

A. Numbers of audits, compilations and reviews performed by the firm

B. Resources of the firm, including the resources provided by service providers

C. Laws, regulations, professional standards, and the environment in which the firm operates

D. Nature and extent of the network requirements and network services, if any

Engagement Question - Solution

Which of the following is **not** a consideration point when assessing risk related to the system of quality management?

A. Numbers of audits, compilations and reviews performed by the firm

B. Resources of the firm, including the resources provided by service providers

C. Laws, regulations, professional standards, and the environment in which the firm operates

D. Nature and extent of the network requirements and network services, if any

Component 2: Governance and Leadership

- Firm assigns **ultimate responsibility and accountability** for the system of QM to the firm's CEO, managing partner (or equivalent) or, if appropriate, managing board of partners (or equivalent).
- Firm assigns the following to designated individuals:
  - Operational responsibility for the system
  - Responsibility for specific **aspects** of the system including compliance with independence requirements and the monitoring and remediation process

Component 3: Relevant Ethical Requirements

- Firm's QM objectives should address the fulfillment of ethical requirements
  - AICPA's Code of Professional Ethics
  - rules of state boards of accountancy
  - rules of applicable regulatory agencies
- The firm, including its personnel should:
  - understand the relevant ethical requirements – also applies to network firms
  - fulfill their responsibilities in relation to the requirements

Component 4: Acceptance and Continuance

  - Establish quality objectives that address the acceptance and continuance of client relationships and specific engagements.
- Consider:
  - Information obtained about the nature and circumstances of the engagement and the integrity and ethical values of the client
  - Firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements
  - Financial and operational priorities of the firm do not lead to inappropriate judgments about whether to accept or continue a client relationship or specific engagement

Component 5: Engagement Performance

- Establish quality objectives that address the performance of engagements:
  - Engagement teams understand and fulfill their engagement responsibilities.
  - Overall responsibility lies with the engagement partner
  - Nature, timing, and extent of direction and supervision of engagement teams and review of the work performed is appropriate based on the engagement and
  - Supervisory review is required by more experienced team members
  - Engagement teams exercise appropriate professional judgment maintain professional skepticism.
  - Consultation on difficult or contentious matters is undertaken, and the conclusions agreed to are implemented.

Component 5: Engagement Performance

Partner Responsibility	Partner May Delegate
Determine that the nature, timing, and extent of direction, supervision, and review is: • performed in accordance with the firm's, professional standards, and applicable legal and regulatory requirements • responsive to the nature and circumstances of the audit engagement and the resources used in the audit.	Direction and supervision of the members of the engagement team and the review of their work
• Review audit documentation at appropriate points in time during the audit engagement, including that related to significant matters, significant judgments, and other matters that the partner believes are relevant to their responsibilities.	
• Determine, through 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 auditor's report, the engagement partner should review the financial statements and the auditor's report and related audit documentation, to determine that the report to be issued will be appropriate in the circumstances.as well as formal written communications to management, those charged with governance, or regulatory authorities.	

Engagement Question

Which of the following is true about the review responsibilities of the engagement partner?

A. The engagement partner can delegate all of the work on the audit except signing the report.

B. The engagement partner is only responsible for reviewing financial statements, the auditor's report and communications to governance.

C. The engagement partner is required to review all workpapers and the financial statements.

D. The engagement partner is required to review audit work relating to significant judgments, the financial statements, the auditor's report and communications to governance.

Engagement Question - Solution

Which of the following is true about the review responsibilities of the engagement partner?

A. The engagement partner can delegate all of the work on the audit except signing the report.

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D. The engagement partner is required to review audit work relating to significant judgments, the financial statements, the auditor's report and communications to governance.

Component 6: Resources

- SQMS 1 expands upon legacy guidance to address:
  - technological resources such as audit tools or IT applications used by the firm for independence monitoring.
  - intellectual resources, such as the firm's methodology, guidance, templates, or tools
  - human resources, which may include people outside the firm used in engagements, including component auditors or engagement quality (EQ) reviewers, service providers and others who are external to the firm.
- Responsibility for all resources lies with the engagement partner
- Partner must determine that the individuals participating in the engagement collectively have the appropriate competence and capabilities, including sufficient time, to perform the engagement

Component 7: Information and Communication

- SQCS 8 did not address the need for information and communication across the system and with engagement teams.
- SQMS 1 includes a component designed to provide guidance on this two-way mechanism to provide a continuous flow of information and communication.
- Firm should implement an information system that contains processes to identify, capture, process, and maintain information.
- Standard is scalable, acknowledging that less complex may accomplish the objective with less rigorous or detailed policies and procedures.
- The standard addresses both internal and external communication.

Engagement Quality Review and Other Reviews

- Role of the EQR could be very important to the QM system.
- SQMS 2 adds more detail - role of the EQ reviewer.
- The use of EQR may be used voluntarily by a firm to address risk or may be required by laws or regulation
  - EQR may be a required response when:
    - entities receive government funding
    - operate in regulated industries such as financial institutions, insurance companies, and pension funds
    - are under management of a court or judicial process such as liquidation.

Engagement Quality Review and Other Reviews

- Firm's EQR policy may also specify EQR for engagements with:
  - high level of estimation uncertainty
  - Engagements that have going concern risks
  - issues that have resulted in internal or external findings,
  - unremediated significant deficiencies or material restatements.
- Firm's policy should be drafted based on the circumstances of the firm.
- Firm should establish specific criteria to enable a consistent determination of the necessity of an EQR.
- Firm may decide that there are no audits or other engagements for which an engagement quality review is necessary

Component 8: Monitoring and Remediation Process

- SQCS 8 focused on engagement level monitoring. SQMS1 focuses on monitoring the system of quality management.
- Proactive response- combination of ongoing monitoring and periodic monitoring
- The objectives of the monitoring system are to provide relevant, reliable, and timely information about:
  - the design, implementation, and operation of the system
  - when deficiencies are noted, take appropriate actions to respond to them on a timely basis.
- Firm should design and perform monitoring activities to provide a basis for the identification of deficiencies.

Component 8: Monitoring and Remediation Process

- In designing the system of quality management, firm leadership considers the nature, timing, and extent of monitoring activities, primarily driven by:
  - Complexity of the firm's engagements
  - How the system is designed
  - Nature and circumstances of the firms and the engagements it performs
  - Extent of changes to the system
  - results of previous monitoring activities
  - whether previous monitoring activities are still relevant
  - whether actions to address identified deficiencies were effective.
- System should also consider any complaints/ allegations

Component 8: Monitoring and Remediation Process

- SQMS 1 defines a deficiency in the firm's system of quality management as instances where:
  - a quality objective required to achieve the objective of the system is not established
  - a quality risk, or combination of risks, is not identified or assessed
  - a response, does not reduce to an acceptably low level the likelihood of a related quality risk occurring because the responses are not properly designed, implemented, or operating effectively
  - an aspect of the system of quality management is absent, or not properly designed, implemented, or operating effectively, so that a requirement of this SQMS has not been addressed.

Component 8: Monitoring and Remediation Process

Periodic monitoring

- A peer review is not a substitute for all monitoring activities.
- Firm's quality management system should provide for internal inspection on a periodic basis.
- Firm's quality management policies may provide that a peer review may be a substitute for the internal inspection for the period covered by the peer review.
- Objectivity is enhanced when the engagement team members or the EQR of an engagement are **not** involved in performing any monitoring activities for that engagement
- Standard does not preclude those individuals from performing inspections.
- To lessen the threat of self-review and the risk that deficiencies may not be detected the system could including safeguards.

Component 8: Monitoring and Remediation Process

Possible Safeguards

- Fostering a commitment to CPE and providing effective training programs so that personnel stay current on accounting, auditing, and quality management standards
- Providing training on how to perform monitoring inspections and requiring the use of peer review or other inspection checklists
- Requiring the passage of time after the completion of an engagement before self-inspections are performed

Component 8: Monitoring and Remediation Process

Responses to address other threats

- Establish strong client acceptance/continuance policies
- Establish consultation policies that require engagement teams to consult when they encounter technical difficulties
- Corrective action in response to the results identified by the firm's internal monitoring, EQR, peer review results or other inspections.
- Require the use of an external service provider to perform engagement quality reviews or monitoring activities when
  - Deficiencies identified in monitoring, peer reviewers, or other external inspections indicate that self-inspection is not effective
  - Changes in conditions and the environment within the firm occur

Evaluating the System of Quality Management

- Evaluate, the system of quality management at least annually.
- Based on the evaluation performed a conclusion should be developed about the system as a whole.
- The two important terms to consider in this evaluation are **severe** and **pervasive.**
- SQMS 1 does not define severe.

Evaluating the System of Quality Management EXAMPLE

An accounting firm performed its internal inspection. During the inspection, the reviewer noted that sampling forms were not being used to document sample size. Firm policy stated that sampling forms were a required workpaper due to peer review comments stating that the rationale for the sample size was not generally evident from the work performed at times appeared to be too low. The reviewer noted that the risk assessment documentation on the majority of engagements reviewed was not updated each year and several practice aids (knowledge of business and internal control documentation) appeared to be rolled forward without change. The reviewer commented that information that was no longer relevant was in the documents as were references to superseded literature. In addition, whenever a service provider was used the audit workpapers included a SOC 1 report, but no work was performed on it. Service providers were used in a significant number of the firm's engagements.

The reviewer concluded that these deficiencies had the same root cause- short cuts were being taken by the staff due to that there was insufficient time on the schedule to complete the engagements. These omissions were not noted by engagement reviewers. **This was deemed to be severe and pervasive.**

Evaluating the System of Quality Management

Person(s) ultimately responsible for the system of quality management should evaluate the system at least annually and conclude on the system.

QM system provides the firm with reasonable assurance that the **objectives of the system are being achieved**.	**Except for** matters related to identified deficiencies that have a **severe but not pervasive effect** on the design, implementation, and operation of the system of quality management, the system of quality management provides the firm with reasonable assurance that the objectives of the system are being achieved.	The system of quality management **does not provide** the firm with reasonable assurance that the objectives of the system of quality management are being achieved.

Evaluating the System of Quality Management

- If the system does not provide reasonable assurance (except for or does not provide) that the system's objectives are being achieved, then prompt corrective action is necessary.
- Person with the ultimate responsibility will communicate to the engagement teams and external parties in accordance with the firm's policies and procedures.
- Communication to the engagement teams is a crucial step in remediating deficiencies.

Networks and Quality Management

- When the firm belongs to a network, the firm should understand:
  - Requirements established by the network regarding quality management. May include using firm network services.
  - Services or resources provided by the network that the firm chooses to implement or use in its system of quality management
  - Firm's responsibilities for any actions that are necessary to implement the network requirements or use network services.
- Firm should evaluate how the requirements fit into its system of quality management and if they need to be adapted or supplemented

Documentation

- Documentation should be sufficient to support a consistent understanding of the system of quality management by personnel
- Includes an understanding of roles and responsibilities in the system and performing engagements.
- Documentation should also be sufficient to:
  - support a consistent understanding of the system by personnel
  - support the consistent implementation and operation of the responses.
  - provide evidence of the design, implementation, and operation of the responses to support the evaluation of the system of quality management.

SQMS 2, Engagement Quality Review (EQR)

- SQMS 2 was issued to highlight the importance of the EQR and to:
  - Clarify that an EQR can be a response to quality risks for any type of engagement. The standard is not just applicable to financial statement audits
  - Highlight the significance of eligibility requirements for the reviewers, the performance and documentation of the EQR
  - Provide a way to clearly differentiate the responsibilities of the firm and the EQ reviewer
  - Increase the scalability of SQMS 1 by not including requirements that would be irrelevant in circumstances when a firm determines that there are no engagements for which an EQR is an appropriate response to address the quality risks

SQMS 2, Engagement Quality Review (EQR)

- Discusses the role of EQ reviewers, characteristics of those individuals necessary to fill the role and those who will assist the reviewer.
- Addresses the authority, competence, and capabilities required to fill the role.
- Highlights the need to include sufficient time to perform the EQR.
- Standard sought to impose limitations on EQ reviewer so that a person that was once the partner does not fill that role for two years. This did **not** make it to the final standard.
- Standard calls EQR to be completed and signed off before the engagement partner's dating of the independent auditor's report.
- The conditions that require an EQR are a firm's judgment.
- EQR may also be a legal or regulatory requirement.

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SQMS 2, Engagement Quality Review (EQR)

To serve as an EQ reviewer the person:

- is **not** permitted to be a member of the engagement team
- should have the competence and capabilities, including sufficient time, and the appropriate authority to perform the EQR
- should comply with relevant ethical requirements, including those addressing threats to the objectivity and independence of the EQ reviewer
- should comply with provisions of law and regulation, if any, that are relevant to the eligibility of the EQ reviewer.
- Reviewer will review selected engagement documentation and evaluate if the engagement documentation supports the conclusions reached and they are appropriate.

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SQMS 2, Engagement Quality Review (EQR)

Reviewer will:

- Evaluate the basis for the engagement partner's determination that independence requirements (when applicable) were met.
- Evaluate whether appropriate consultation has taken place on difficult or contentious matters or differences of opinion and the conclusions
- For audit engagements the reviewer will evaluate whether the engagement partner's involvement has been sufficient and appropriate throughout the engagement

SQMS 2, Engagement Quality Review (EQR)

- EQ reviewer will review the following documentation

Audits	Financial statements and independent auditor's report, including, if applicable a description of key audit matters.
Reviews	Financial statements or financial information and review report
Other engagements	Engagement report and subject matter information (if applicable).

SQMS 2, Engagement Quality Review (EQR)

- EQ Reviewer will notify the engagement partner if concerns arise about the significant judgments made by the engagement team.
- If concerns cannot be resolved to the satisfaction of the EQ reviewer, they should notify the appropriate person in the firm that the EQR cannot be completed.
- Once the review is complete, the EQ reviewer will notify the engagement partner that the report can now be issued.
- EQ reviewer may complete the documentation after the report release date but before the 60-day documentation completion period is over.

Engagement Question

Which of the following is required of the EQ Reviewer?

A. Review risk assessment workpapers, the financial statements, auditor's report and communications to governance

B. For audits evaluate independence documentation and documentation on contentious issues or differences of opinion, determine whether the partner had an appropriate level of engagement involvement and review the financial statements, auditor's report and key audit matters, if applicable.

C. It is up to the EQ reviewer to determine what they need to review.

D. None of the above are true.

Engagement Question - Solution

Which of the following is required of the EQ Reviewer?

A. Review risk assessment workpapers, the financial statements, auditor's report and communications to governance

B. For audits evaluate independence documentation and documentation on contentious issues or differences of opinion, determine whether the partner had an appropriate level of engagement involvement and review the financial statements, auditor's report and key audit matters, if applicable.

C. It is up to the EQ reviewer to determine what they need to review.

D. None of the above are true.

SAS 146, Engagement Quality Management

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

SAS 146, Engagement Quality Management

- Engagement partner may assign certain tasks to others within the engagement team.
- Partner should be appropriately involved throughout the engagement
- Partner working alone -some requirements can't be followed
- The phrase "take responsibility for…" -the engagement partner is permitted to assign the certain activities to experienced team members.
- Requirements specify that the engagement partner **should** do something- the engagement partner is required to conduct that activity.
- Partner responsible for meeting legal and ethical requirements.

SAS 146, Engagement Quality Management

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

SAS 146, Engagement Quality Management

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

SAS 146, Engagement Quality Management

Supporting engagement performance.

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

SAS 146, Engagement Quality Management

Monitoring and Remediation

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

Taking Overall Responsibility for Managing and Achieving Quality

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

Audit and Disclosure Issues

Audit and Disclosure Issues

- AICPA consistently calls out the need for firms to improve their processes and documentation regarding risk assessment
- SAS 145 does not overhaul the risk assessment process. Instead, it:
  - Offers better explanations for terminology that have been in audit literature for years but that the AICPA believe have been misunderstood.
  - Includes more specificity around the auditor's understanding of internal control especially technology and control activities
  - Includes more focus on professional skepticism
  - Provides a new definition for significant risk
  - Requires separate evaluations for inherent risk and control risk

SAS 145 –Risk Assessment

- Risk at the financial statement level and assertion level.
  - Financial statement level- broad, relates to more than one account balance/class of transaction
    - Lack of segregation of duties that spans the organization rather than just one specific area
    - Management override
    - Ineffective governance
- Assertion level- the auditor evaluates only significant account balances, classes of transactions and disclosure for risk.

SAS 145 – Interrelated Definitions

- **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** without regard to internal controls.
- **Relevant Assertion-** to be relevant an assertion must have an identified risk of material misstatement. To determine if an assertion has an identified risk of material misstatement the auditor would evaluate it for the likelihood that the risk that would occur and the magnitude if it did. The standard of evaluation is reasonable possibility. Both likelihood and magnitude need to be present for an assertion to be relevant.

SAS 145 – Interrelated Definitions

- **Reasonable Possibility-** In this context the term reasonable possibility refers to a risk **less than probable** (also defined as likely) but **more than remote.** Since a risk of material misstatement may relate to more than one assertion. Where that is the case, all the assertions related to the risk are relevant assertions.
- **Material-** The standard states that for material classes of transactions, account balances, or disclosures that have not been determined to be significant classes of transactions, account balances, or disclosures, the auditor should evaluate whether their determination remains appropriate near the end of the audit.

SAS 145 – Inherent Risk

- **Inherent risk factors-** characteristics that affect susceptibility to misstatement of an assertion about a class of transactions, account balance, or disclosure (quantitative or qualitative)
  - Subjectivity
  - Complexity
  - Change
  - Uncertainty
  - Susceptibility to misstatement due to management bias or fraud
- Auditor uses inherent risk factors to evaluate events or conditions that affect an assertion's susceptibility to misstatement.
- Concept of the **spectrum of inherent risk**.

SAS 145 – Inherent Risk

Significant Risk

- Risk is a **significant risk** when it is higher on the spectrum of inherent risk **or** is a risk that is required to be treated as a significant risk in accordance with an AU-C section such as the risk of fraud and significant unusual transactions with related parties.
- Overall financial statement risks do not need to be assessed to determine if they meet the definition of significant risks.

SAS 145 – 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.**

SAS 145 – Inherent Risk

2. Account balance and assertion: Accounts receivable, valuation

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

The client believes that each year 5% of revenue should be reserved as an allowance. In prior audits, adjustments have been made because the client's customers have more risk than the industry average. Due to the change in accounting principles, the allowance for bad debts should anticipate the amount of credit risk for all receivables, even those that are current.

Since the client uses 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

SAS 145 – Inherent Risk

3. 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

Engagement Question

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

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

Engagement Question- Solution

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

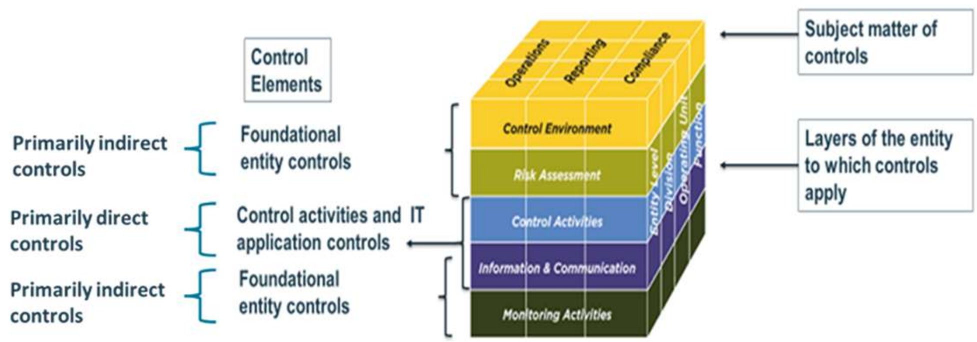
A. Direct and indirect.

B. Significant and fraud.

C. Overall financial statement and assertion level.

D. Audit and credit.

SAS 145 –Control Risk



Auditor is required to obtain an understanding of each of the 5 levels of internal control. No changes to when controls are required to be tested from previous guidance.

Peer Review Findings Resulting in MFCs

- Following are other areas identified as issues in peer reviews, which resulted in MFCs in engagements with year-ends between 3/01/2021 and 6/31/2022.
- Failure to appropriately document planning procedures, including:
  - Risk assessment (and linkage of risks to procedures performed)
  - Planning analytics. Note that the requirements for planning analytics will change effective with SAS 145. The auditor is not required to set an expectation for preliminary analytics. The standard says it is helpful to do so, but not required.
  - Failure to communicate and/or document required communications with those charged with governance. This is important especially since SAS 134 adds a new requirement. The auditor should communicate significant risks to governance in the planning stage of the audit.

Peer Review Findings Resulting in MFCs

- Failure to properly support and document the assessed level of risk in accordance with professional standards including:
  - Setting control risk at less than high without testing the effectiveness of controls
  - Performing risk assessment at the audit level rather than at the relevant assertion level
  - Failure to document linkage between risk assessment procedures and actual substantive procedures performed
  - Failure to document fraud risk assessment procedures regarding inquiries with those in charge of governance and response to management override of controls
  - Failure to appropriately address fraud considerations related to revenue recognition

Peer Review Findings Resulting in MFCs

- The AICPA believes auditors have an inadequate understanding of the procedures necessary to document the auditor's understanding of internal control.
- SAS 145 clarifies which aspects of the entity's system of internal control are integral to the risk assessment process and the level of work that is necessary in obtaining the required understanding.
- Primarily indirect controls- understanding will be more robust.
- Since the understanding of the process flows occurs as the auditor understands the entity and its environment and not at the relevant assertion level, the understanding of **identified controls** is limited to targeted areas.

Primarily Indirect Controls

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.

Primarily Indirect Controls

Level of Internal Control	Understanding Required- SAS 145
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.

Primarily Indirect Controls

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 This 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 then evaluate whether the entity's process for monitoring the system of internal control is appropriate to the entity's circumstances considering the nature and complexity of the entity.

Primarily Indirect Controls

Level of Internal Control	Understanding Required- SAS 145
Information and Communication	Evaluate aspects of the information and communication components 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 Includes communication of significant matters Does not require the auditor 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.

SAS 145 –Risk Assessment

More Robust Understanding of IT

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

SAS 145 –Risk Assessment

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

SAS 145 –Risk Assessment

More robust understanding of GITC is likely necessary when:

- 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

SAS 145 –Risk Assessment

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

SAS 145 –Risk Assessment

Lack of Segregation of Duties

- Many auditors have clients that lack of segregation of duties.
- May be a targeted risk over a specific part of the financial reporting system or may be pervasive.
- 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.

Engagement Question

The auditor is required to obtain an understanding of internal controls for all but which of the following?

A. Controls that address a risk that is determined to be a significant risk
B. Controls over all systems that process transactions
C. Controls over journal entries and other adjustments
D. Controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence

Engagement Question - Solution

The auditor is required to obtain an understanding of internal controls for all but which of the following?

A. Controls that address a risk that is determined to be a significant risk
B. Controls over all systems that process transactions
C. Controls over journal entries and other adjustments
D. Controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence

Understanding Design and Implementation of Internal Control

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

Understanding Design and Implementation of Internal Control

- Peer reviewers have noted that auditors are failing to document walk-through procedures performed.
- A **walk-through** - 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, **but** inquiry **alone** is not sufficient to determine whether a control has been implemented.

Issues Identified in Engagement Wrap-up

- Failure to obtain appropriate management representation letters. Specifically, auditors have failed to:
  - Update the letter to include all representations required by the applicable professional standards
  - Date the letter appropriately
  - Include appropriate financial statement periods
  - Include required representations
  - Include appropriate wording concerning consultation with an attorney
- Failure to include audit documentation that contains sufficient competent evidence to support the firm's opinion on the financial statements
- Insufficient review of audit documentation

Engagement Question

Which of the following is true regarding internal controls as described in AU-C 315 (current standard) but more explicitly stated in SAS 145, the updated risk assessment standard?

A. The auditor is primarily required to understand controls over control activities.
B. The auditor is required to understand internal controls over the controls that management thinks are the most important in managing the entity.
C. The auditor is required to obtain an understanding of each of the 5 components of internal control.
D. The auditor is only required to obtain an understanding of controls over significant risks and areas where substantive tests alone are not able to provide sufficient audit evidence.

Engagement Question- Solution

Which of the following is true regarding internal controls as described in AU-C 315 (current standard) but more explicitly stated in SAS 145, the updated risk assessment standard?

A. The auditor is primarily required to understand controls over control activities.
B. The auditor is required to understand internal controls over the controls that management thinks are the most important in managing the entity.
C. The auditor is required to obtain an understanding of each of the 5 components of internal control.
D. The auditor is only required to obtain an understanding of controls over significant risks and areas where substantive tests alone are not able to provide sufficient audit evidence.

Issues Identified in Accounting and Disclosure- Revenue Recognition

- ASC 606 is now effective for all entities.
- Firms are now undergoing peer reviews for the first time after the implementation of ASC 606 and as expected, more Matters for Consideration (MFCs) are being issued in this area.
- AICPA published the first wave of comments for audits, reviews, and compilations.
- MFCs citing FASB ASC 605, the old revenue standard was generally not a significant percentage of total MFCs issued.
- In 2021 approximately 13% of MFCs that cited an ASC section were related to revenue recognition.
- MFCs citing ASC 606 were categorized in three areas 1). failure to consider the standard, 2) failure to test the client’s implementation of the standard and 3) inadequate disclosures.

Issues Identified in Accounting and Disclosure- Revenue Recognition

- **Failure to consider FASB ASC 606 in the engagement**
  - Based on MFCs issued it appears that that firms were confused about the effective date of ASC 606.
- **Failure to make appropriate disclosures required under FASB ASC**
  - Lack of disclosure appeared to be an even more significant issue
- **Firm did not document consideration of ASC 606 and there was no evidence that the client implemented it- Review Engagement**
- **MFC:** On a review engagement, ASC 606 was not implemented as required by GAAP, and there is no evidence that implementation was considered.

Issues Identified in Accounting and Disclosure- Revenue Recognition

- **Peer reviewer could not find testing of the client's implementation of ASC 606 and disclosures were inadequate**
- **MFC:** The reviewer noted two audits where revenue recognition under the new standard was not appropriately tested nor were disclosures in the financial statements adequate.
- The lack of appropriate understanding of the applicable standards led to the review and audit engagements being considered non-conforming with professional standards.
- **MFC:** During our review of a construction contractor review, we noted the company had not implemented the current professional standards of ASC 606 which had an implementation date effective for this engagement's year end. The FASB did not defer the effective date by one year until after these statements were issued.

Issues Identified in Accounting and Disclosure-Revenue Recognition

- **Disclosures related to ASC 606 were inadequate**
- ASC 606 made significant changes to disclosure requirements for revenue from contracts with customers.
- Stakeholders felt that the disclosures under the old standard were not robust enough
- Regulators believed that the disclosures related to revenue lacked cohesion with the disclosure of other items in the financial statements making it difficult to understand an entity's revenues, as well as the judgments and estimates made by the entity in recognizing those revenues.
- **MFC:** A reviewed financial statement of a technology company with multiple revenue streams had missing or incomplete disclosures relating to revenue recognition standard.
- Specifically, the disclosures did not include significant judgments made in applying the guidance; disaggregated revenue recognized from contracts with customers into categories that depict the nature, amount, and timing of revenue; an explanation regarding how the timing of satisfaction of performance obligations relates to the typical timing of payment; and the types of warranties, obligations for returns, and refunds.

Issues Identified in Accounting and Disclosure-Revenue Recognition

- **MFC:** The financial statement notes indicated that ASC 606 was adopted with no quantitative changes. Some required disclosures were omitted including qualitative information about its contracts with customers, significant judgments made in applying the guidance, performance obligations including warranties, and transaction price including variable consideration.
- **MFC:** Contract balance disclosure was incomplete, omitting opening balances of receivables. This matter will be elevated for inclusion in a FFC (Finding for Further Consideration).

Issues Identified in Accounting and Disclosure-Revenue Recognition

- **Specific ASC 606 Disclosure Omitted More than Others**
- ASC 606 provides for abbreviated disclosure for private companies in several areas. It requires the entity to disclose both the opening and closing balances of receivables, contract assets, and contract liabilities, if not otherwise separately presented or disclosed. A comparative presentation will still require the opening balance of these accounts to be disclosed for the prior year.
- The AICPA Peer Review Checklist for General Audits was updated in October 2021 to add several new pages dedicated to FASB ASC 606 recognition and measurement.

Other Accounting and Disclosure Findings

Subsequent events

- Failure to disclose the date through which subsequent events were evaluated
- Failure to consider subsequent event disclosures related to potential negative financial impact due to COVID-19

General Disclosure Findings

- Failure to correctly classify long term debt on the cash flow statements
- Failure to include a statement of cash flows
- Failure to correctly segregate liabilities into current and noncurrent classifications
- Failure to include required disclosures on policies related to goodwill
- Failure to report long-term debt for the next five years
- Failure to properly classify current liabilities in the firm compiled classified balance sheets
- Failure to properly disclosed risks and uncertainties
- Standard use of estimates language was included but there were areas of complex estimates where more disclosure was needed.

General Disclosure Findings

- Allowance for doubtful accounts. Some disclosures are worded so that it appears the direct write off method is used.
- Inadequate disclosure of PPP and/or SBA loans including accounting treatment
- Failure to disclose pledged assets
- Operating lease obligations. Disclosure will become significantly more robust when ASC 842 is effective for 2022 calendar year ends.
- Classification basis and cost determination for inventory
- Shares authorized, issued and outstanding for capital or common stock

General Disclosure Findings

- Fair value hierarchy of investments,
  - Description of the levels
  - Description of the assumption methods used and tabular presentation of amounts.
- Peer reviewers are reporting that auditors are not performing sufficient procedures or documenting the procedures to obtain assurance of fair value measurements.

Disclosure- NFP Findings

- GAAP for NFP is found in ASC 958. Auditors do not always have the industry knowledge.
  - Financial related entities
  - Split interest agreements
  - Financial Statement Presentation
  - Statement of cash flows
  - Investments
  - Debt
  - Contingencies
  - Business Combinations
  - Revenue Recognition

NFP Findings

- In addition, the AICPA also issues Technical Questions and Answers on topics pertinent to not-for-profits. (TQA Section 6140)
- Healthcare entities are often not-for-profit. Their industry GAAP requirements can be found in ASC 954. TQAs for healthcare entities are found in Section 6400.
- Peer reviewers have concluded that some auditors do not have the industry knowledge necessary for these engagements.
- Independence
  - Failure to appropriately document assessment of the SKE of staff designated to oversee non-attest/non-audit services
  - Failure to document application of safeguards to eliminate threats or reduce them to an acceptable level
  - Modifications to engagement and representation letters related to management's responsibilities for overseeing nonaudit/nonattest services

NFP Findings- Disclosure

- Failure to disclose qualitative and quantitative management of liquid resources
- Failure to provide sufficient information on the presentation of functional expenses
  - Not all expenses were included in the functional expense presentation
  - Cost of goods sold or other elements of exchange transactions such as direct donor benefits were improperly categorized as fundraising
- Independence
  - Failure to appropriately document assessment of the SKE of staff designated to oversee non-attest services
  - Failure to document application of safeguards to eliminate threats or reduce them to an acceptable level
  - Modifications to engagement and representation letters related to management's responsibilities for overseeing nonaudit/nonattest services

Other NFP Findings

- Failure to include all periods covered by the financial statement in the management representation letter
- Failure to include disclosures regarding risks and uncertainties
- Failure to use updated terminology including "with and without donor restrictions"
- Failure to properly present net assets, functional expenses and/or liquidity in financial statements

Other NFP Findings

- Failure to implement current professional standards regarding qualitative information that is useful in assessing liquidity and qualitative information that communicates how the entity manages its liquid resources available to meet cash needs within one year of the date of the statement of financial position
- Failure to include all required elements in the auditor's report including:
  - statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements
  - statement that the supplementary information is the responsibility of management and was derived from, and related directly to, the underlying accounting and other records used to prepare the financial statements

Other NFP Findings

- Failure to implement current professional standards regarding qualitative information that is useful in assessing liquidity and qualitative information that communicates how the entity manages its liquid resources available to meet cash needs within one year of the date of the statement of financial position
- Failure to include all required elements in the auditor's report including:
  - statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements
  - statement that the supplementary information is the responsibility of management and was derived from, and related directly to, the underlying accounting and other records used to prepare the financial statements

Single Audit Issues

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Single Audit Issues

- The Single Audit is a form of compliance audit, made more complex because of the number of regulations that auditors are required to follow.
- The number of nonconforming single audits jumped from 18% in 2018 to 40% in 2020.
- The Single Audit has been a source of concern for auditors for over 30 years.
- Each year the AICPA publishes a list of issues that have surfaced in peer reviews, oversight reviews and reviews by government agencies.
- When issues are identified by federal government agencies, often it will result in a referral to the AICPA ethics division.

Single Audit Issues- Independence

- **Independence-** Auditors are failing to document the engagement team's consideration related to independence.
- When the auditor performs nonaudit services for a client in a Yellow Book audit, the auditor determines if any of the services to be provided are prohibited. If not, then the auditor will want to determine where there may be significant threats that need to be mitigated by safeguards.
- Preparation of financial statements- when this service is provided the auditor should determine whether they are preparing the statements for the client in their entirety or assisting in the preparation.
- The 2018 Yellow Book states that when preparing a client's financial statements in their entirety from the client's trial balance or underlying accounting records, firms should conclude that significant threats to independence exist.
- When a firm encounters significant threats to independence, the firm should apply safeguards to eliminate or reduce the threats to an acceptable level.

Single Audit Issues- Independence

- Example safeguards:
  - Removing an individual from an audit team when their financial or other interests/relationships could pose a threat.
  - Consulting a third party; for example, a member of a professional association such as the AICPA or of a professional regulatory body such as the GAO or another auditor.
  - Not including individuals who provide non-audit services as engagement team members.
  - Having another auditor review the audit and non-audit work.
  - Engaging another audit organization to evaluate the results of the non-audit service.
  - Having another audit organization reperform the non-audit service to the extent necessary.

Management's Responsibility & SKE

- When the auditor performs a nonaudit service management is not required to be able to reperform it, but they do need to be able to take responsibility for it.
- Management is required to appoint someone with the appropriate knowledge, skills, or experience to oversee the nonaudit service.
- 2018 Yellow Book made a change that says an indicator of this ability is that they can identify a material error, omission, or misstatement in the nonaudit service provided.
- Peer reviewers have noted that auditors are failing to adequately document this assessment.

Management's Responsibility & SKE

EXAMPLE

An auditor was documenting the SKE related to the firm's preparation of financial statements. He documented the conclusion as follows:

"Bill Jones, accounting manager, was designated as the person who would be responsible for oversight of the nonaudit service we provide, specifically the preparation of financial statements. Bill has been in his role at the client for 10 years. He regularly oversees the accounting practices of the company. He is knowledgeable about GAAP and when questions arise over financial reporting matters, he is skilled at research. He consults with the firm when he has questions. Based on our assessment we believe that Bill has the knowledge, skills, and experience to identify a material error, omission, or misstatement in the nonaudit service provided."

Schedule of Expenditures of Federal Awards (SEFA)

- Management should provide a complete and accurate SEFA to the auditor so that the appropriate major programs will be chosen by the auditor and the appropriate dollar level of expenditures be reflected in the schedule.
- Failure to have a complete and accurate SEFA could result in the 1) incorrect separation of programs into Type A and Type B, 2) programs being left off the schedule and not having the opportunity to be selected as major programs, 3) programs classified as Type B when they are actually Type A programs.
- Peer reviewers have reported that the amounts reported on the SEFA did not reconcile to the financial records.
- This is a has been a source of referral to the AICPA Ethics division by federal agencies.

COVID Environment

- COVID Environment has caused issues for entities. The following have been noted by reviewers
  - Funding is sometimes provided with insufficient documentation to the awardee. There may also be addenda to an agreement that provides support for the award that is sent to the awardee at a later time.
  - Some federal agencies disbursed funding with no formal grant agreement. Without a grant agreement there is no expenditure for SEFA purposes. However, grant documentation could be in the form of an email or another form.
  - More funding is being passed down to subrecipients. Sometimes it is not clear to the subrecipient that the award is federal money.

COVID Environment

- OMB asked federal agencies to identify programs they believed to be high risk (noted in the 2021 and 2022 compliance supplement)
- When noted in the compliance supplement as higher risk the auditor should consider them to be major programs **unless** the program otherwise meets the criteria for a low-risk Type A program **and** the percentage of COVID-19 funding in the program or other cluster during the nonfederal entity's fiscal year **is not material** to the program or other cluster as a whole.

SEFA Presentation Issues

- The SEFA did not indicate whether awards were direct or pass-through. Although the term direct does not have to be used the caption should be- *Federal Grantor/Pass-through Grantor/Program or Cluster Title.*
- The SEFA did not identify awards received as a subrecipient. The SEFA should include the name of the pass-through entity and the identifying number of the pass-through entity.
- Amounts passed through to subrecipients are included in a separate column on the face of the schedule.
- Multiple lines for CFDA/Assistance Listing numbers were shown, but the total expenditures for the CFDA/Assistance Listing number was not included.
- The SEFA did not clearly indicate the total federal expenditures and/or federal expenditures by program.
- The following issues were identified that could cause errors in the audit because the SEFA did not include, or mistakes were made, when including the following:
- Not all programs were included on the SEFA. This was especially true of noncash awards.

SEFA Presentation Issues

- The programs that were parts of a cluster were not shown that way
- The correct CFDA/Assistance Listing number was not reported.
- Research and Development (R&D) programs were not identified as such.
- The SEFA presentation requires footnotes. In many cases the footnotes were inadequate. The required notes to the SEFA are:
  - Basis of presentation
  - Summary of significant account policies- cash or accrual basis
  - Indirect cost rate (whether **or not** the de minimis rate was elected)
- There may be other footnotes required as well (loans, commingled funds, grant specific requirements)

SEFA Documentation Issues

- The audit documentation did not indicate what procedures were performed relating to the schedule of expenditures of federal awards.
- Deficiencies noted in documenting the testing of the SEFA. One of the most significant was the reconciliation between the SEFA and the accounting records used to prepare the financial statements.
- The auditor's understanding of design and implementation of internal controls over the preparation of the SEFA was not adequately documented.
- Auditors did not report internal control issues noted with the SEFA.

Engagement Question

Which of the following is true regarding the auditor's work and documentation related to independence.

A. Auditors are not documenting the SKE of the client personnel responsible for overseeing the nonaudit service.
B. The auditor must consider assisting the client with the preparation of financial statements to be a significant threat.
C. The auditor may be able to mitigate threats to independence by not including individuals who provided the nonaudit service as engagement team members.
D. Auditors are able to use the SKE of the client as safeguards.

Engagement Question- Solution

Which of the following is true regarding the auditor's work and documentation related to independence?

A. Auditors are not documenting the SKE of the client personnel responsible for overseeing the nonaudit service.

B. The auditor must consider assisting the client with the preparation of financial statements to be a significant threat.

C. The auditor may be able to mitigate threats to independence by not including individuals who provided the nonaudit service as engagement team members.

D. Auditors are able to use the SKE of the client as safeguards.

Major Program Documentation Issues

- Failure to combine expenditures with the same Assistance Listing numbers.
- Failure to identify and test enough major programs and the correct major programs. This stems from not understanding the guidelines for coverage.
  - The low-risk auditee is a two year look back at past single audits. This is not always considered leading to an incorrect determination of risk.
- Failure to properly consider loans in major program assessments.
- Type A and B program determination was based on budgeted or appropriated amounts instead of actual expenditures.
- In other instances, the determination was based on prior year amounts instead of actual expenditures, rounded amounts instead of actual expenditures, or preliminary amounts instead of actual expenditures after adjustments.
- Use of incorrect threshold for Type A/Type B program determination.

Issues with Risk Based Approach

- Once major programs are selected the auditor identifies the programs for risk
- The criteria for assessment are identified specifically for Type A programs in the guidance (program must be audited in one of the two most recent audit periods.
  - The following may **not** have been present in the immediate prior year
    - Internal control deficiencies which were identified as material weaknesses in the auditor's report on internal control for the program
    - A modified opinion on the program in the auditor's report on the program.
    - Known or likely questioned costs that exceed five percent of the total federal awards expended for the program.
  - Other criteria that can be used to assess risk in a Type A programs are:
    - Oversight by Federal Agencies and results of follow up procedures and changes in systems affecting the program

Issues with Risk Based Approach

- Not appropriate to use high inherent risk as a criteria
- For Type B the requirements are general as discussed in the UG.
- After the programs are identified as to risk the auditor will audit all **not low risk** Type A programs and Type B programs capped at no more than 25% of the number of low-risk Type A programs.
- If the auditor assesses a Type B program as high risk, then it must be audited.

Issues with Risk Based Approach

- Type A program were inappropriately considered low risk even though they had not been audited as a major program in the last two years.
  - The two year look back is the first criteria the auditor assesses.
  - If the program was not audited as major in the one of the two most recent audit periods, the program is considered **not low risk** and no further consideration is necessary.
- Type A programs not qualifying as low risk were not audited as major programs.
- Type B program risk determined on a global basis rather than on an individual program basis.
- Percentage of coverage requirements were not met. (20% for low-risk auditee, 40% otherwise).

Issues with Risk Assessment Process

- Distinction between risk-based approach and risk assessment process.
- Part 2 of the Compliance Supplement identifies the applicable compliance requirements for each program.
- Auditor evaluates the applicable requirements to determine if they are direct and material
- For those that are direct and material the auditor will assess inherent risk which includes assessing the presence of significant risks as well as assessing the risk of fraud.
- After the auditor tests internal controls over the direct and material compliance requirements, control risk is assessed.
- If no compliance supplement the auditor uses Part 7 to build one and then determines which applicable requirements are direct and material.

Identifying Compliance Requirements

EXAMPLE

An auditor chose the Supplemental Nutrition Assistance Program. (AL# 10.511) as a major program. Part 2 of the Compliance Supplement showed the following.

Program	A	B	C	E	F	G	H	I	J	L	M	N
10.511	**Y**	**Y**	**Y**	N	**Y**	**Y**	N	N	N	**Y**	N	N

The applicable compliance requirements are A-activities allowed, B-allowable costs, C-cash management, F-equipment and real property management, G-matching level of effort and earmarking, and L-reporting. The rebuttable presumption is that the auditor will test them. However, if the requirement is not direct and material to the major program then the auditor is not required to test it. Bear in mind that if the auditor believes that violation of that requirement could have a material effect on the opinion on the financial statements, he/she should test it anyway.

Issues with Risk Assessment Process

- Most significant deficiencies noted in the risk assessment process by peer reviewers -failure to analyze, conclude and properly document that an applicable compliance requirement either did not apply to the auditee or that noncompliance could not have a direct and material effect on a major program.
- Other deficiencies noted were:
  - No documentation or inadequate documentation of inherent risk factors providing a rationale as to why a direct and material compliance requirement was considered low risk.
  - Internal controls were not documented or properly tested, or documentation was lacking.
- Failure to assess the level of materiality for each major program

Direct and Material Compliance Requirements

- The auditor considers the following criteria when determining if a compliance requirement is direct and material:
  - Noncompliance could likely result in questioned costs.
  - The requirement affects a large part of the federal program (i.e., program dollars).
  - Noncompliance could cause the federal agency, or pass-through entity to take adverse action against the entity, such as seeking reimbursement of all or a part of the award and suspending the entity's participation in the program.
- The auditor should also be aware that materiality is based on qualitative, as well as quantitative aspects.

Sampling in a Single Audit

- Identified as a risk area in the Audit Advisory section of the Compliance Supplement (2021 and 2022)
- Peer reviewers and regulators have noted that auditors are not using the appropriate sampling techniques and that the documentation of the auditor's sampling plan is not sufficient or is not included in the workpapers.
- AICPA has included specific charts and instructions in the GAS/Single Audit Guide to assist auditors in choosing sample sizes and for sampling documentation.
- Includes suggested minimum sample sizes for tests of controls over compliance and tests of compliance based on certain engagement-specific inputs.
- Chapter 11 in the Audit Guide is a good resource

Sampling in a Single Audit

- Sampling applications are more likely to be used for control activities than entity level controls (primarily indirect controls).
- In a dual-purpose test, the auditor identifies the control to be tested and evaluates the compliance requirements that could be tested using the same selections.
- One good example would be testing controls over allowable costs and testing compliance for the auditor's assessment of whether the costs are allowable or not.
- When using a dual-purpose application, it is important to use the **larger** of the two sample sizes that would have been computed if the attributes were tested separately.
- Peer reviewers have said that they cannot always tell the difference between the internal controls over compliance and the compliance tests

Sampling in a Single Audit- Inherent Risk

- Auditors should ensure that they maintain the appropriate linkage by using the same value (L, M, H) as in the risk assessment process.
- If the assessment has changed for some reason by the time the auditor is testing internal controls, the risk assessment needs to be modified as well.

Sampling in a Single Audit- Inherent Risk

- Factors that are considered in the assessment of inherent risk are:
  - Length of time client has worked with the program.
  - Complexity of the processing (routine transactions vs. nonroutine, systematic vs. nonsystematic, manual vs. programmed) or judgment involved.
  - Significant deficiencies or material weaknesses in internal control identified in the past.
  - Notification from program officials that indicates there are potential problems.
  - Lack of compliance in the prior year.
  - High volume of activity.
  - Substantial change in policies, processes, or personnel associated with the requirement.
  - High client turnover in grant programs.
  - Program has been identified as higher risk by the OMB in the Compliance Supplement.

Sampling in a Single Audit- Choosing the Sample

Control Testing Sample Size Table – Population 250 or More Items	
Significance of Control and Inherent Risk of Compliance Requirement	**Minimum Sample Size with 0 Deviations Expected**
Very significant and higher inherent risk	60
• Very significant and limited inherent risk or • Moderately significant and higher inherent risk	40
Moderately significant and limited inherent risk	25

Sampling in a Single Audit- Choosing the Sample

Small Population Sample Size Table	
Frequency and Population Size	**Sample Size**
Quarterly (4)	2
Monthly (12)	2-4
Semi-monthly (24)	3-8
Weekly (52)	5-9

Sampling may be performed using haphazard, random or systematic methods. sample should be representative of the population.

Sampling in a Single Audit- Interpreting the Results

Acceptable Errors	LOW					MODERATE			HIGH		
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0	114	76	57	45	38	32	28	25	22	15	11
1	194	129	96	77	64	55	48	42	38	25	18
2	265	176	132	105	88	75	65	58	52	34	25
3	331	221	166	132	110	94	82	73	65	43	32

Base sample sizes assume zero deviations from the control. This chart illustrates what to do if there are more errors than anticipated.

Sampling in a Single Audit- Interpreting the Results

- Dual purpose- testing a control and a compliance attribute at the same time.
- If the results of control testing demonstrate that controls are not effective, a larger sample size will result for testing compliance.

Compliance Testing Sample Size Table	
Controls risk is assessed at:	**Sample Size**
High	60
Moderate	40
Low	25

- When programs are designated as higher risk, a larger sample size is expected.
- Certain programs may designate higher sample sizes for compliance.

Peer Review Issues Noted-Sampling

- Sampling plan and methodology was not adequately documented including:
  - Basis for sample size.
  - Rationale for items selected.
  - Analysis of exceptions.
  - Conclusions after testing.
- The auditor used inadequate sample sizes.
  - This may stem from not using the sampling methodology set forth in the audit guide and defaulting to a sample of 25 or 40.

Peer Review Issues Noted-Sampling

- Improperly performed and/or documented dual-purpose tests.
- Sample design issues
  - Omitting part of the population, or entire categories, from the sampling plan
  - Not remembering that it is important when a selection is not applicable to use sampling with replacement techniques.

Peer Review Issues Noted-Internal Control

- Internal control test exceptions were noted. However, no explanation was given as to why the exception was not included as an audit finding or effect on planned compliance testing.
- Internal control testing consisted solely of discussing internal controls with management.
- Eligibility was tested for compliance using information from the client's IT system. However, there was no testing of the controls over the technology or source information.
- Failure to consider a lack of segregation of duties and other similar internal control weaknesses as internal control deficiencies requiring communication to management and others.
- Failure to consider the impact of the results of internal control testing on the sample for testing compliance.

Compliance Testing

- The auditor tests each direct and material compliance requirement according to the procedures identified in the Compliance Supplement.
- If there is no Compliance Supplement available for the program, then the auditor will use Part 7 of the Compliance Supplement to identify the audit requirements from the program document.
- Use Part 3 of the Compliance Supplement for the general tests of the compliance requirements
- Use Part 4 of the Compliance Supplement to test specific requirements, if any, that are applicable to the program.
- The grant documentation may also contain provisions that are important to test. Issues identified by peer reviews and federal agencies were:

Peer Review Issues Noted-Compliance Testing

- The auditor did not follow the guidance in Part 7 of the Compliance Supplement for identifying the applicable compliance requirements to test when no supplement was available for the major program.
- The sampling application for compliance tests was not properly documented.
- Compliance requirements that have a direct and material effect on each major program were not properly identified.
- The auditor did not complete all the steps that are necessary to test compliance that are included in the Compliance Supplement and the reasons why were not documented.

Peer Review Issues Noted-Compliance Testing

- The most recent edition of the Compliance Supplement was not used.
- The documentation of major program amounts tested did not agree with the amounts shown on the SEFA
- Compliance requirements were not sufficiently tested, or out-of-date audit programs were used.
- The auditor did not consider that agency requirements changed during the year and tested the population the same way.

Peer Review Issues Noted- Reporting

- Desk reviewer can recalculate the major programs selected, identify issues with clusters and issues with reporting language.
- These issues may result in referral to the AICPA and could also result in a workpaper review by a federal agency. Issues noted:
  - Required elements were omitted from the auditor's report, including:
    - reference to the audit being performed in accordance with *Government Auditing Standards*,
    - no identification of the entity's major funds and opinion units presented in a governmental entity
    - no reference to include prior year financial statements when comparative years were presented
    - the word “independent” was omitted from the report title
    - reporting on supplementary information or RSI, or referring to that reporting, was omitted

Peer Review Issues Noted- Reporting

- Management indicated they would correct the finding, so it was not considered a finding.
- Exceptions were noted but not included as audit findings or otherwise resolved.
- The auditor issued a separate report which was not part of reporting package, of "non-material Noncompliance" with audit findings which appeared to meet the definition of an audit finding.
- Findings were poorly worded and did not include all of the required information or elements.
- The client did not carry forward certain prior-year findings to the current-year's summary schedule of prior audit findings and the auditor failed to mention that omission in the report.
- The language in the reports on the SEFA, on compliance and on internal control over financial reporting required by *the Yellow Book*, or on compliance with requirements applicable to each major program and on internal control over compliance was inappropriate or the reports were omitted entirely.

Peer Review Issues Noted- Reporting

- There was a lack of consistency in the amounts or items reported in results of the single audit between the auditor's report, the data collection form, and the SEFA
- Reports were not updated to conform to the changes in the AICPA report forms.
- The report on the financial statements did not refer to the reports on internal controls and compliance.
- Significant deficiencies or material noncompliance with *Yellow Book* were not reported.
- Issuance of an unmodified opinion on compliance with requirements applicable to major programs when there were material instances of noncompliance.

Peer Review Issues- Other Issues Identified

- Failure to properly document evaluation of management's skills, knowledge, or experience to effectively oversee nonaudit services that the auditor performed.
- Failure to obtain written management representations tailored to the entity and governmental audit regarding federal awards.
- Failure to document required communications with those charged with governance.
- Questioned costs exceeding the audit finding dollar thresholds were deemed immaterial.
- Workpaper stated that more work was needed to resolve an issue; however, the additional work was not documented.
- Documentation did not support the requirements of AU-C 240 including inadequate documentation of fraud discussions with audit staff and auditee management, and failure to adequately consider fraud risks when designing audit procedures.

Peer Review Issues- Other Issues Identified

- Documentation did not indicate the disposition of prior audit findings and proper consideration of current potential significant deficiencies and other findings.
- Failure to use written audit programs, tailor audit programs for specialized industries, specific transactions, or balances, or to sign off on audit programs.
- Auditors relied on testimonial evidence obtained from management and employees, without obtaining corroborating evidence and documentation.
- Reliance on inadequate or outdated reference material, including outdated versions of the Compliance Supplement or federal audit guide for program-specific audits. Many instances were noted in workpaper reviews where outdated terminology was used creating an impression that old reference materials were used.
- Reliance on audit programs that do not address all applicable single audit requirements.

Employee Benefit Plan Issues

KAPLAN

SAS 136- Employee Benefit Plans

- Employee benefit plans are an area of significant risk
- SAS 136 includes new requirements that impact every part of an audit of ERISA plan financial statements (EBP audit). This includes:
  - Engagement acceptance
  - Risk assessment and response
  - Communication with those charged with governance
  - Performing procedures
  - Reporting

Employee Benefit Plans-Management Responsibilities

- Auditor will obtain agreement in engagement and rep letter that management is responsible for:
  - Maintaining a current plan instrument, including all plan amendments.
  - Administering the plan and determining that the plan's transactions that are presented and disclosed in the financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants to determine the benefits due or which may become due to such participants.
  - Considering the plan's ability to continue as a going concern for the period of time specified in the entity's financial reporting framework.
  - Providing the auditor, prior to the dating of the auditor's report, with a draft of the Form 5500 that is substantially complete. Where this was an ideal situation before SAS 136, it is now a requirement.
  - Other representations related to management's election of the ERISA 103(a)(3)(C) audit

Employee Benefit Plans- ERISA Section 103(a)(3)(C)

- Auditor is not required to audit any statements or information related to assets held for investment of the plan prepared by a bank, similar institution, or insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency, if
  - the investment information is prepared and certified to as complete and accurate by the qualified institution and
  - management elects to have an ERISA Section 103(a)(3)(C) audit.
- The ERISA 103(a)(3)(C) audit is similar to what was previously referred to as the limited scope audit.

Employee Benefit Plans- ERISA Section 103(a)(3)(C)

- SAS 136 establishes a new type of auditor's report for 103(a)(3)(C) audits. The auditor expresses an opinion whether:
  - the amounts and disclosures in the financial statements, other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with the applicable financial reporting framework,
  - the information in the 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 a qualified institution.

Employee Benefit Plans- ERISA Section 103(a)(3)(C)

- The auditor will express an opinion on the ERISA-required supplemental schedules that the form and content of the supplemental schedules, **other than** the information that agrees to or is derived from the certified investment information
- The benefit plan reports were also updated to conform to the format and language in SAS 134.

Employee Benefit Plans- Certifying Entity

- In old limited scope audits peer reviewers note that the entity certifying the investment information was not qualified
- The auditor will now require management to make a representation that:
  - An ERISA Section103(a)(3)(C) audit is permissible under the circumstances
  - The investment information is prepared and certified by a qualified institution, as described in 29 CFR 2520.103-8 of the Department of Labor’s (DOL’s) Rules and Regulations for Reporting and Disclosure under ERISA
  - The certification meets the requirements in 29 CFR 2520.103-5
  - The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework.
  - The election of the ERISA Section 103(a)(3)(C) audit does not affect management’s responsibility for the financial statements.

Employee Benefit Plans- Reportable Findings

- SAS 136 requires the auditor to add reportable matters to the communications with those charged with governance.
- Reportable findings are:
  - An identified instance of noncompliance or suspected noncompliance with laws or regulations
  - A finding that is significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process
  - An indication of deficiencies in internal control identified during the audit that have not been communicated to management by other parties and are of sufficient importance to merit management’s attention
    - A good example of a reportable matter would be where management was not administering the plan according to the plan document.
    - Unlike other communications to governance, SAS 136 requires the auditor to communicate reportable findings, in writing.

Employee Benefit Plans- Issues Noted

- Auditor failed to perform an appropriate risk assessment including assessing risk at the assertion level
- Auditor did not support inherent risk assessments
- Auditor did not properly link audit procedures performed to the risk assessment
- Auditor did not document their understanding of controls including IT and complementary user controls, and did not appropriately test controls
- Auditor did not provide adequate documentation over tests of operating effectiveness on key complementary user controls for a SOC® report where the auditor relied on controls
- Control risk was assessed at **less than** high without obtaining a SOC® report or performing other control testing

Employee Benefit Plans- Issues Noted

- Auditor failed to perform or document sufficient procedures over participant data, participant contributions, benefit/distribution payments or income allocation to participant accounts
- Auditor failed to perform or document sufficient procedures to conclude whether employer contributions were correctly calculated
- Auditor failed to appropriately include sufficient documentation so an experienced auditor could understand the nature, timing and extent of procedures performed, the results of procedures performed, the audit evidence obtained, conclusions reached, and any professional judgments used
- Auditor failed to identify, and report prohibited transactions
- Auditor failed to sufficiently document how the how they properly test plan document compliance or plan attributes based on the Plan document in effect for the year under audit
- The auditor's report and financial statements stated use of modified cash basis; however, various receivables and disclosures seemed to indicate preparation on a GAAP basis

Issues Noted by SMEs and Others- Risk Assessment

- Auditors are not properly performing procedures to gain an understanding of internal control when identifying risk. This sometimes occurs because the auditor believes there are no controls.
  - The auditor is required to obtain an understanding of internal controls. If there really are no controls, then the auditor is not likely to be able to obtain sufficient information to render an opinion on the financial statements.
- Auditors fail to assess the risk of material misstatement at the financial statement and account balance/class of transaction level for significant account balances/classes of transactions.

Issues Noted by SMEs and Others- ERISA 103(a)(3)(C) audits.

- The same issues that affected the limited scope audit are likely to affect the ERISA 103(a)(3)(C) audits.
- Failure to understand testing requirements on limited scope audit (now ERISA103(a)(3)(C) audits)
- Improper use of limited scope exemption because financial institution did not qualify for the exemption.
- Issues with the certification itself (e.g., qualification of the institution is not appropriate, the certification doesn't include the appropriate reference to complete and accurate or the certification is not signed).
- Failure to test the areas that are not certified by a qualified institutions (receivables, payables, participant accounts, etc.)

Issues Noted by SMEs and Others- Use of Technology

- The auditor should design and perform tests of controls:
  - to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls
  - if the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively
  - substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level.

Issues Noted by SMEs and Others- SOC Reports

- The DOL continues to identify deficiencies in auditor’s work related to the SOC report noting that auditors perform too little testing on it.
- Some auditors are not aware that **obtaining** a service auditor's report is only the first step in the work that needs to be performed.
- Once the user auditor obtains the SOC report they will read it to determine whether the service auditor's report provides enough evidence about the effectiveness of the controls to support the user auditor's risk assessment:
  - Whether it is a SOC 1 type 1 or type 2 report and if the report is the correct report
  - The period of time covered by the report if it is a type 2 report (e.g., for the year ended December 31, 20XX).
- Complementary user entity controls are not being properly understood, confirmed for implementation, or tested if control reliance is planned.

Issues Noted by SMEs and Others- SOC Reports

- Subservice Organizations
  - If the user auditor plans to use a type 1 or a type 2 report that excludes the services provided by a subservice organization and those services are relevant to the audit they should obtain evidence related to the controls of the subservice organization (usually their SOC report, if available).
  - Peer reviewers have noted that often auditors will not consider the effect of subservice organizations.

Issues Noted by SMEs and Others- SOC Reports

- Peer reviewers have noted that user auditors do not always consider the results of the testing of service organization's controls by the service auditors.
- User auditor should evaluate whether the tests of controls performed by the service auditor and the results described in the service auditor's report, are relevant to the assertions in the user entity's financial statements.
- User auditor should also evaluate whether any deficiencies noted by the service auditor during their tests of controls adversely affect the internal controls at the service organization.

Engagement Question

An auditor was performing a full-scope audit of a defined contribution plan. The activity in the investment accounts was processed by a financial institution. The entity booked the entry to the financial statements but did not perform a rigorous review of the purchases and sales. The auditor obtained a SOC report from management which was prepared by a service auditor. Which of the following would be the best to obtain relative to the investment activity?

A. SOC 1 Type 2 report
B. SOC 2 Type 1 report
C. It is possible to confirm investments, so no SOC report is necessary
D. SOC report on the subservice organization

Engagement Question - Solution

An auditor was performing a full-scope audit of a defined contribution plan. The activity in the investment accounts was processed by a financial institution. The entity booked the entry to the financial statements but did not perform a rigorous review of the purchases and sales. The auditor obtained a SOC report from management which was prepared by a service auditor. Which of the following would be the best to obtain relative to the investment activity?

A. SOC 1 Type 2 report
B. SOC 2 Type 1 report
C. It is possible to confirm investments, so no SOC report is necessary
D. SOC report on the subservice organization

Issues Noted in Peer Review- Testing Forfeitures

Testing of Participant Data and Forfeitures

Deficiency	Key Issues
No audit work performed or no audit documentation of participant accounts	GAAS requires testing allocation of total net assets to participant accounts
Insufficient testing of payroll data	Failure to obtain confirmation from participants
No testing of participant eligibility or forfeitures	Obtaining payroll data
No testing of investment income allocation to participants	• Defining eligibility requirements • Obtaining forfeiture information
Inadequate or missing documentation	Testing allocation of investment income to participant accounts

Issues Noted in Peer Review- Testing Investments

Deficiency	Key Issues
No audit work performed or no audit documentation	GAAS requires testing of fair value of investments confirmed by the Trustee (full scope audit)
Failure to test fair value measurements	Obtaining Common Collective Trust Funds unit values
Failure to obtain proper certification (limited scope- now ERISA103(a)(3)(C) audits)	Understanding the nature of investments
Inadequate or missing disclosures related to fair value related to ASC 820	Assessing proper disclosure and supplemental schedules
Failure to evaluate and/or document the evaluation of investment contracts for benefit responsiveness in define contribution plans	• Following up on inconsistencies on the custodian reports and supplemental schedules. • Qualifications of appraisal firm • Understanding assumptions used in appraisal report
• Failure to disclose investments that represent 5% of more of plan net assets • Failure to identify valuation of employer stock in the risk assessment (ESOP) • No or insufficient testing performed on appraisal/valuation report of employer stock (ESOP) • Obtaining and reviewing documentation of employer stock transactions (ESOP)	Obtaining the information required for employer stock ASC 820 disclosures for ESOPs.

Issues Noted in Peer Review- Testing Participant Data

Deficiency	Key Issues
No audit work performed or no audit documentation	• Establishing payroll • Testing authorization of elective deferrals register used in testing is reliable
Insufficient testing on contributing employer for multi-employer plans	Defining compensation
Documentation of testing internal controls for payroll	Lack of documentation
Failure to test employee elective deferrals	• Obtaining confirmation responses • No alternative procedures performed
Timeliness of participant contributions not tested	

Issues Noted in Peer Review

Participant Benefit Distributions & Withdrawals/Benefit & Claim Payments

Deficiency	Key Issues
No audit work performed or no audit documentation	Eligibility to receive benefits
Failure to test participant eligibility to receive benefit payments	• Determining and testing when distributions are permitted • Obtaining confirmation responses
Failure to test approval of benefit payments	View cancelled checks or verification of proper receipt

Related Parties/Parties in Interest/Prohibited Transactions

Deficiency	Key Issues
No audit work performed or no audit documentation	Identifying related parties/parties in interest
No or incomplete related parties/parties in interest noted in workpapers	• Definition of prohibited transactions • Financial statement disclosures and supplemental schedules • Effect on auditor's report

Other Issues Noted in Peer Review

- Inadequate disclosures related to participant-directed investment programs
- Incomplete or erroneous description of the plan and its provisions
- Failure to properly report on and/or include the required supplemental schedules relating to ERISA and DOL
- Failure to appropriately document sample size determination.

Engagement Question

An auditor of a defined benefit plan. The client's specialist, an actuary developed the accrual and the presentation and disclosure information relative to the plan's pension liability. Which of the following best describes the auditor's responsibility related to the pension information in the financial statements?

A. If management's specialist provided the information and the actuary is a pension actuary, then the auditor only has to trace the information received from the actuary to the general ledger and to the footnotes.
B. The auditor will need to perform procedures related to the quality of the actuary, test the underlying data if significant and evaluate the output of the specialist to ensure it meets the standards of the financial reporting framework.
C. The auditor will need to test internal controls around the work of the actuary.
D. The auditor only needs to understand whether the actuary is reputable and has a history of quality work.

Engagement Question- Solution

An auditor of a defined benefit plan. The client's specialist, an actuary developed the accrual and the presentation and disclosure information relative to the plan's pension liability. Which of the following best describes the auditor's responsibility related to the pension information in the financial statements?

A. If management's specialist provided the information and the actuary is a pension actuary, then the auditor only has to trace the information received from the actuary to the general ledger and to the footnotes.
B. The auditor will need to perform procedures related to the quality of the actuary, test the underlying data if significant and evaluate the output of the specialist to ensure it meets the standards of the financial reporting framework.
C. The auditor will need to test internal controls around the work of the actuary.
D. The auditor only needs to understand whether the actuary is reputable and has a history of quality work.

Accounting & Review Issues

Accounting & Review Services- Preparation Engagements

- Items identified as deficiencies by peer reviewers
  - Disclosure of items, such as an uncertainty, is not required in financial statements in which substantially all the disclosures required by the applicable financial reporting framework are omitted
  - Failure to disclose the fact that substantially all disclosures have been omitted on the face of the financial statements
  - Failure to include a statement that indicates that no assurance is provided on the financial statements
  - Failure to disclose departures from the financial reporting framework including the omission of the statement of cash flows

Accounting & Review Services- Compilation Engagements- Issues Noted by Peer Reviewers

- Accountants report noted that substantially all of the disclosures were omitted when that was not the case.
- Certain disclosures were missing when substantially all other disclosures are presented.
  - This is considered a departure from the applicable financial reporting framework, and the nature of the departure and its effects, if known, should be disclosed.
- Failure to disclose that compiled financial statements that omit substantially all disclosures were prepared using a special purpose framework and the basis of accounting is not readily determinable from reading the report.

Accounting & Review Services- Compilation Engagements- Issues Noted by Peer Reviewers

- Accountant used antiquated report forms.
- Reports did not always specify the date or period covered by the financial statements.
- Reports did not always include a separate paragraph when supplementary information accompanies financial statements.
- Reports did not always include a separate paragraph that includes the required elements when reporting on financial statements that omit substantially all disclosures required by the applicable financial reporting framework.
- Lack of independence is not always cited when this is the case.

Accounting & Review Services- Disclosure Issues Noted by Peer Reviewers for Comps and Reviews

- Significant departures from the financial statement formats prescribed by industry accounting and audit guides- missing
- Omission of disclosures related to significant accounting policies applied (whether GAAP or special purpose framework).
- Failure to include a summary of significant assumptions in a financial forecast or projection
- Failure to segregate the statement of cash flows into components- operating, investing, and financing activities. Failure to consider all noncash financing and investing activities.

Accounting & Review Services- Disclosure Issues Noted by Peer Reviewers for Comps and Reviews

- Failure to disclose the cumulative effect of a change in accounting principle.
- Failure to disclose significant related party transactions
- Omission of financial statements that are noted in the report.
- Failure to include one or more statements of cash flows when comparative results of operations are presented in accordance with GAAP.

Accounting & Review Services- Issues Noted by Peer Reviewers for All Levels of Service

- Engagement letters- must be in writing and signed.
- Peer reviewers have noted that accountants often fail to:
  - Use the updated SSARS language in the engagement letter.
  - Include the expected form and content of the accountant's compilation report, including the report modification when the accountant's independence is impaired (comp only).
  - Identify the applicable financial reporting framework for the preparation of the financial statements.
  - Identify nonattest services to be provided, objectives of the services, management's responsibility for the services, and the limitations of the services.

Accounting & Review Services- Issues Noted by Peer Reviewers for Review Engagements

- Peer reviewers have found that accountants are not always:
  - Specifying the date or period covered by the reviewed financial statements
  - Including section headings
  - Indicating the degree of responsibility, if any, the accountant is taking with respect to supplementary information that accompanies financial statements and the accountant's review report.

Accounting & Review Services- Issues Noted by Peer Reviewers for Review Engagements

- Unlike compilation engagements, a management representation letter is required for review engagements.
- Specifically, peer reviewers have noted that accountants:
  - Fail to request all required representations
  - Fail to request representations that are dated as of the date of the accountant's review report
  - Fail to request representations for all periods covered by the review.

Review Procedures- Issues Identified

- Peer reviewers have noted that accountants are not:
- Properly documenting the rationale for development of analytical procedures and the basis for the accountant’s expectations
- Evaluating whether the expectation is sufficiently precise
- Properly documenting the comparison of recorded amounts or ratios developed from recorded amounts to expectations

Review Procedures- Issues Identified

- Peer reviewers have noted that accountants are not properly documenting:
  - Materiality
  - Significant unusual events and transactions and their disposition
  - Significant findings or issues identified in the review

Reminders

- ❑**Post event evaluation:** Please complete the course evaluation that will be pushed out to you as a pop up link on your screen. We welcome your feedback!

KAPLAN