An AICPA Clarity Audit Standards Update—The Time is Now!

Western Intergovernmental Audit Forum
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Arizona Office of the Auditor General

Our objectives for this session

The Clarified Auditing Standards

- The Time is Now!
- High level discussion about the (more) significant changes
- Understand what may change your policies and procedures now that the standards have "clarity"
  - Important: Group Audits has been the most difficult to understand

Clarity Project status

- SASs 117-120
  - Currently effective
- SASs 122-127
  - Effective audits of CY 2012/ FY 2013 financial statement audits
- One SASs not yet clarified
  - Use of Internal Auditors—Exposure Draft released
- Clarified SASs codified with new section numbers designated “AU-C”
- Codification is what you want to use!

- ***SAS 122 – Most of the new AU-C sections***
- ***SAS 123 – Cleanup***
- ***SAS 124 – Another country***
- ***SAS 125 – Restricted alert***
- ***SAS 126 Going concern***
- ***SAS 127 - Cleanup***

Clarity format

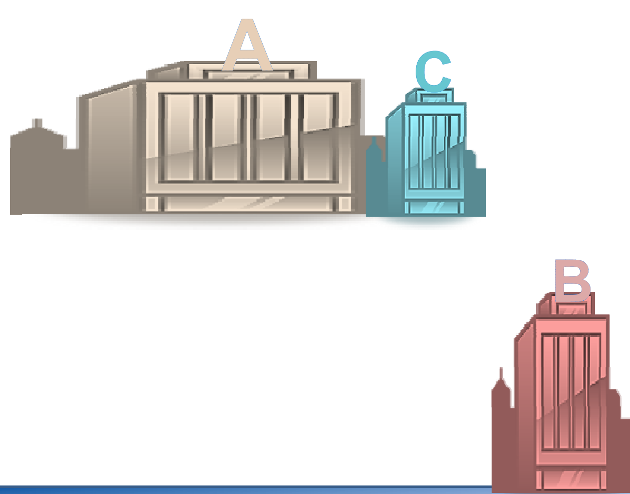
- Introduction
- Objectives
- Definitions
- Requirements
- Application Material
- Appendices and Exhibits

Introduction
— 1 askdjfaklsjdfkljakljkljakljdkfljaklsfkl
— 2 asdkjfklajkfjkasjkfjklsdfjakjfjasf;
— 3 kdlfkaljdsfjkasjf
Objectives
— 4 jasdkfjaksjd
— 5 kasldfjkakjfkalk
Definitions
— 6 adkf
— 7 asdlkfjk
Requirements
— 8 aksdjklajksdfkaklsdfklajsklfdjklasjfklj
— 9 aksdjfajskdfjaksjdfklajklsfjklajkslfjk
— 10 asjdhfjajsdf;lkakklaklfdklasjf
— 11 aksjdkjajdfkakjdfklasfklaklsfdk
Application Material
— A1 kdsa;jklsdkfjlka;sjdkljklajsdkl
— A2 kf9idnavlk;askdljfkalk
— A43 skjdfaoieiklajkllk
Appendix A (e.g., illustrative reports, lists)
— A44 iukjds;aksiejklajklklvja
Exhibit A (e.g., requirements in other SASs)
— ncfji;efklaklkasjdlkfalklk

Special considerations

- Audits of smaller, less complex entities
  - An audit is an audit
- Audits of governmental entities
  - State audit organizations
  - Opinion units
  - Laws and regulations, e.g., “withdrawal from engagements”
- Accounting standards neutrality

Group Audits is about components



Group Audits—How it all got started

Current AICPA	International Standards	Clarified AICPA
• Make reference to work of others • Divided responsibility	• "Group" auditor has responsibility • No making reference • Group tells other auditors what to do	• "Group" auditor has responsibility • Making reference is basis for evidence • Group assumes responsibility for components not referenced

How is an audit affected by Group Audits?

During a F/S Audit . . .	*While you're at it . . .*
Under-stand the Entity	• Identify components • Understand components and consolidation process • Decide which components are significant
Develop Audit Plan	• Determine if significant components have component auditors and get an understanding • Determine whether to/if you can make reference
Determine Materiality	• Determine component materiality for those components you are not making reference to and take into account components for which you are making reference

How is an audit affected by Group Audits?

During a F/S Audit . . .	*While you're at it . . .*
Perform procedures to respond to RMM	• Test consolidation processes • When making reference, make communications to component auditor(s)
Evaluate evidence	• Review communications and audit reports of component auditors you will be making reference to
By-the-way, if you don't make reference	• Be involved in the component auditor(s) work *note: this involves a significant increase in the group auditor's procedures*

Identifying components

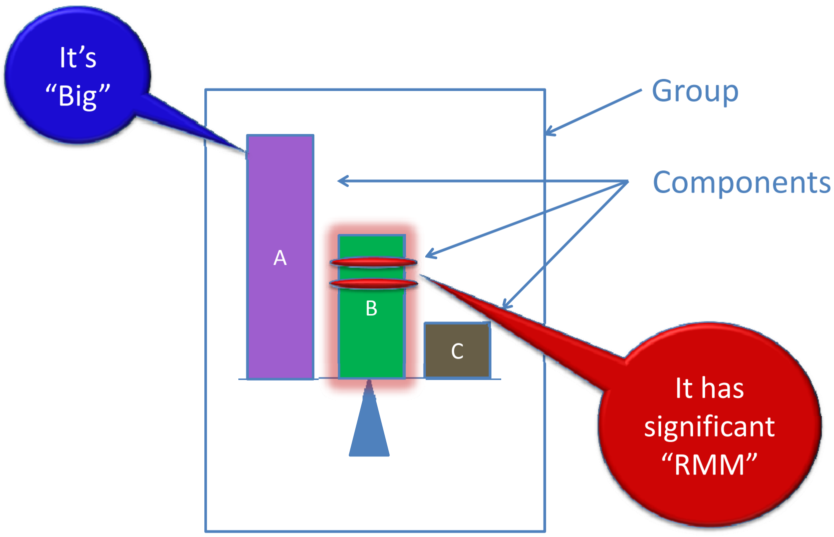
Some "sure things" ???

- When you need to make reference to the work of other auditors
- When investments accounted for under the equity method

Key questions to ask???

- My #1 – how does management prepare its financial statements; specifically, when do they have to incorporate financial information differently than from its own financial information system(s)?

What makes a component significant?



Why do we care if components are significant?

Financially Significant Component	Risk-based Significant Component	Non-significant Components
• Audit of financial information (adapted as necessary) using component materiality	• Audit financial information (adapted as necessary) using component materiality • Audit (adapted as necessary) of one or more class of transactions related to the risk • Specific audit procedures designed to address the risk	• Analytical procedures to determine if significant risks of material misstatements • If additional significant risks of material misstatements are identified, using auditor judgment, apply requirements of risk-based significant components

A final thought

Q. Do the procedures required for group audits in a financial statement audit apply to federal compliance (i.e., SAS 117 audit) procedures?

A. Yes. But this is still unsettling and unsettled territory. What are the most likely places group audits applies?

- Relying on other auditors who audit major programs
- Auditing major programs when the administration of a major program has "components"

The biggest issues for Group Audits???

- Identifying components, but not over identifying
- Determining significance of components, but finding the "sweet spot" for what is significant
- New requirements for dealing with component auditors
  - Whether we can make reference
  - Scaling procedures when component auditors are us
- Applying materiality at the group and component levels

Reporting

Headings and Subheadings

Opinion

Other auditor reporting responsibilities (Yellow Book Report reference)

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

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

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Reporting

Basis for qualified, adverse, or disclaimer (placed before opinion paragraph)

Modified opinion (Qualified, Adverse, or Disclaimer

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheet as of December 31, 20X1, and the related consolidated statements of income, changes in stockholders' equity and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

Basis for Adverse Opinion

As described in Note X, the Company has not consolidated the financial statements of subsidiary XYZ Company that it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis by the Company. Under accounting principles generally accepted in the United States of America, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements referred to above do not present fairly the financial position of ABC Company and its subsidiaries as of December 31, 20X1, or the results of their operations or their cash flows for the year then ended.

Report on Other Legal and Regulatory Requirements

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

[Auditor's signature]

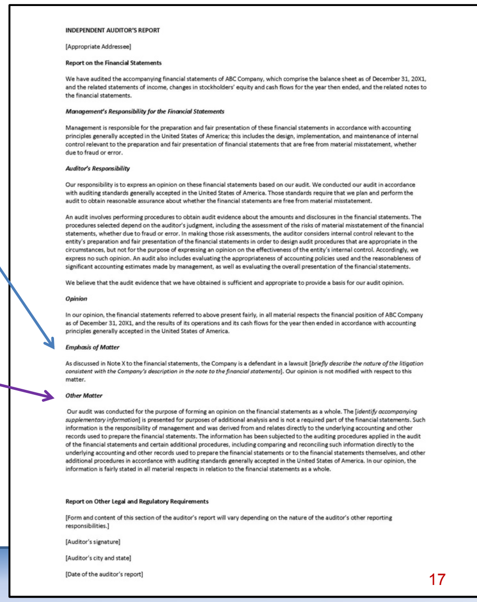
[Auditor's city and state]

[Date of the auditor's report]

Reporting

Emphasis of Matter
- Matters appropriately presented or disclosed

Other Matter
- To understand audit matters (Combining statements, SI, RSI, SEFA)



INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit [*briefly describe the nature of the litigation consistent with the Company's description in the note to the financial statements*]. Our opinion is not modified with respect to this matter.

Other Matter

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [*identify accompanying supplementary information*] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Report on Other Legal and Regulatory Requirements

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

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Special Considerations—Special Purpose Frameworks (AU-C 800)

	Cash Basis	Tax Basis	NEW! Other basis	Contract-ual	Regulatory	
					Restricted	General
Opinion	Single	Single	Single	Single	Single	Dual
Describe Purpose	No	No	No	Yes	Yes	Yes
Use EOM?	Yes	Yes	Yes	Yes	Yes	No
Restrict use?	No	No	Yes	Yes	Yes	No

Special Considerations—Special Purpose Frameworks (AU-C 800)

	Cash Basis	Tax Basis	NEW! Other basis
Opinion	Single	Single	Single
Describe Purpose	No	No	No
Use EOM?	Yes	Yes	Yes
Restrict use?	No	No	Yes

A basis of accounting that utilizes uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

Restricted use communications

- Communicating internal controls
- Communications with governance
- Supplementary information "in relation to" (optional)
- Summary F/S
- Single F/S or Elements
- Compliance with Aspects of Agreements
- Reports on application of GAAP
- Letters for Underwriters
- Compliance audits
- Special purpose frameworks
- Group audits

What the big deal is

Requirements Elements	Impact on Practice
• Restricted use language ▪ Criteria suitable for limited parties ▪ Criteria available to limited parties ▪ Matters outside primary objective of audit	• Names specific parties in language • Inability for others to use ▪ Currently implicit/ overlooked ▪ Under Group Audits AU-C 600, not allowed • (For governments) Big disconnect

What's changed

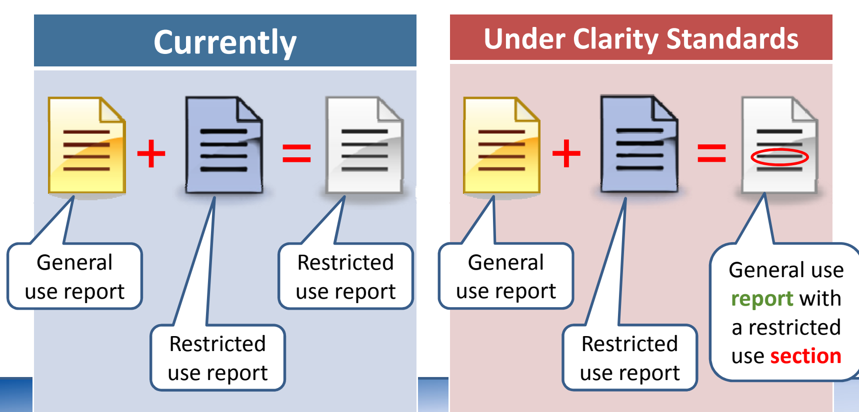
Requirements Elements	What's Different
• Restricted use language ▪ Criteria suitable for limited parties ▪ Criteria available to limited parties ▪ Matters outside primary objective of audit	• Exception for 3rd criteria if also following GAGAS ▪ Don't name specific parties ▪ Removes disconnect ▪ Removes Group Audits conflict • Now uses language about "intended purpose"

Restricted use versus restricted purpose

"Restricted" Use	"Restricted" Purpose
"This [*report, letter, or communication*] is intended solely for the information and use of [*list or refer to the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties."	"The purpose of this [*report, letter, or communication*] is to [*describe the purpose of the communication*]. Accordingly, this [*report, letter, or communication*] is not intended to be and should not be used for any other purpose."

One more subtle change

Remember when we combined restricted use reports with general use reports?



Questions?