Audit Update 2024

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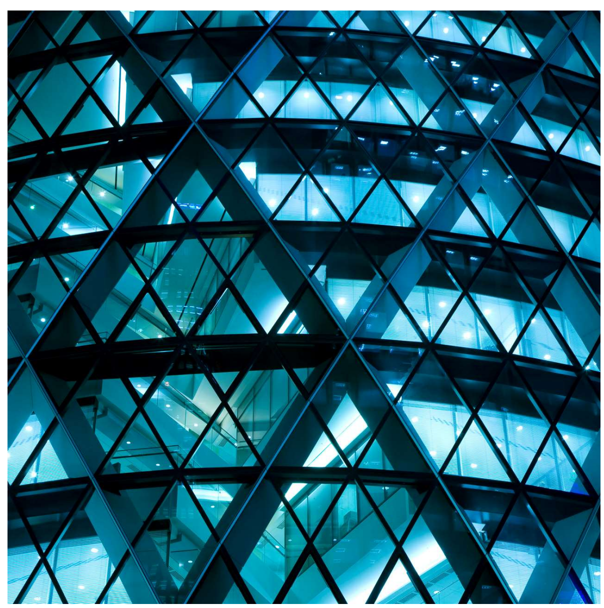
1

Agenda

- Risk Assessment and ITGC’s
- Estimates
- Group Audits



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Objectives

- To recognize and articulate the changes in SAS 145 from prior risk assessment standards
- To understand how to best document and scale risk assessment for a less complex entity
- To identify the three types of IT General controls and what documentation is required and when
- To identify what is considered to be a group audit and once identified to identify the audit consequences of being a group audit
- To determine how the audit of estimates has changed and what procedures need to be performed

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Newly effective and not yet effective standards

Standard	Description	Effective date
SASs		Audits of financial statements for:
142	Audit Evidence	Periods ending on or after December 15, 2022
143	Auditing accounting estimates and related disclosures	Periods ending on or after December 15, 2023
144	Use of specialists and use of pricing information	
145	Risk assessment	
146	Quality Management for Engagements	Periods beginning on or after December 15, 2025
147	NOCLAR	Periods **beginning** on or after June 30, 2023
148	Amendments to AU-C 935, *Compliance Audits*	Split to be consistent with SAS 142 and with SAS 143, based on specific amendment
149	Group Audits	Audits of group financial statements for periods ending on or after December 15, 2026.

Early implementation permitted.

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Risk Assessment SAS 145

5

Risk Assessment (SAS 145)

Let's start with some basics and build from there

Can you answer these questions?

For a particular account, is it possible that there are assertions not considered relevant?	What are the factors influence inherent risk?	When is a process understanding required to be documented?
When is an evaluation of design and implementation required and how is it different from a process understanding?	Has the definition of significant risk changed?	If risk is determined to be significant, what audit documentation/procedures are now required?

6

6

Risk Assessment Considerations/Challenges

- What comes first – the understanding or the assessment?
- Iterative nature – how do you manage change during the engagement?
- Are there efficient ways to document?
- Does your audit methodology/practice aides own you or do you own them?
- Can you identify HOW risk assessment has made you a more effective auditor?
- Can you identify how risk assessment has made you a more efficient auditor?

7

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Are Your Audits More Lucky than Good?

Proper risk assessment focuses your audit effort where it matters.

It is BOTH a QUALITY play and an EFFICIENCY play.

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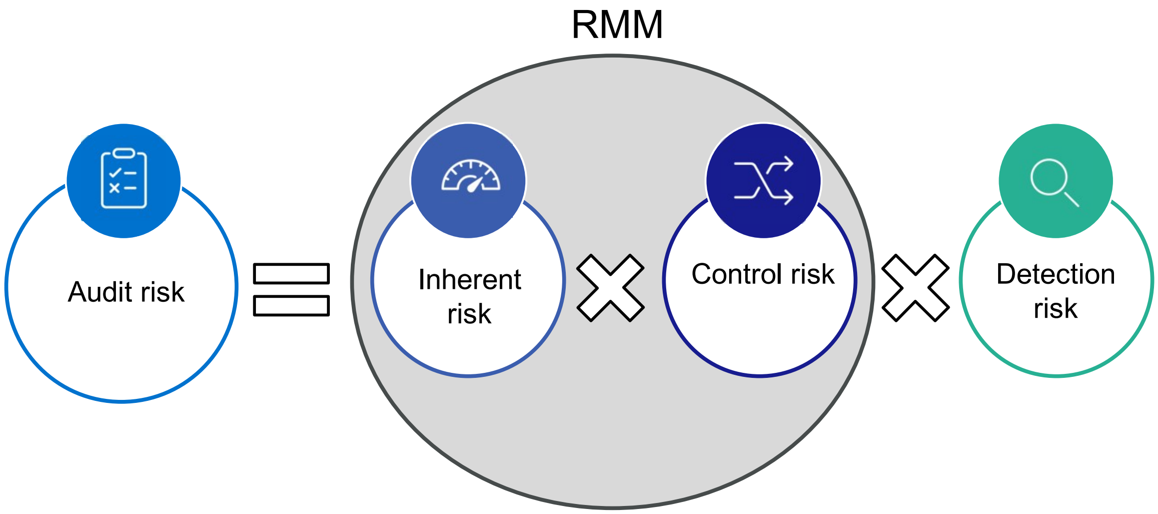
Audit Risk Model



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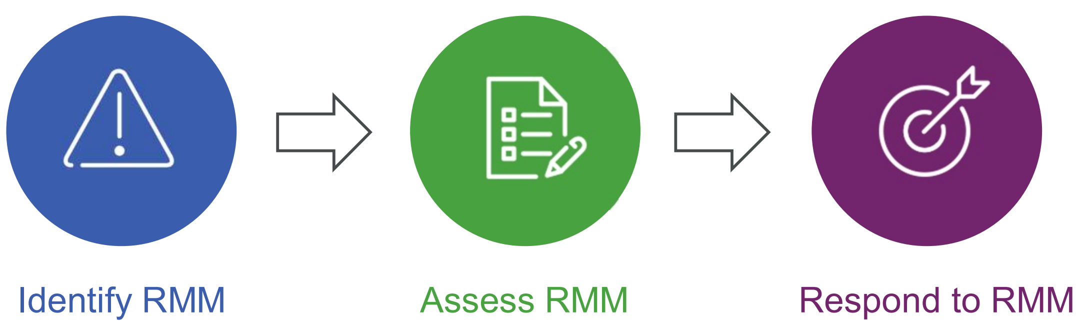
What the Audit is all about – this is the core of every audit



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Assessing Risk

- Separate assessments of Inherent Risk & Control Risk are required
- Combined risk is IR x CR which equals Risk Material Misstatement.
  - To know RMM you need to know materiality and the benchmark for calculating it (such as assets, revenue, equity, EBITDA, etc.)
- If CR is at the maximum – then RMM equals IR
- RMM impacts the nature and extent of procedures
- Choose wisely = this impacts everything you do or don't do

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Inherent Risk

The susceptibility of an assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

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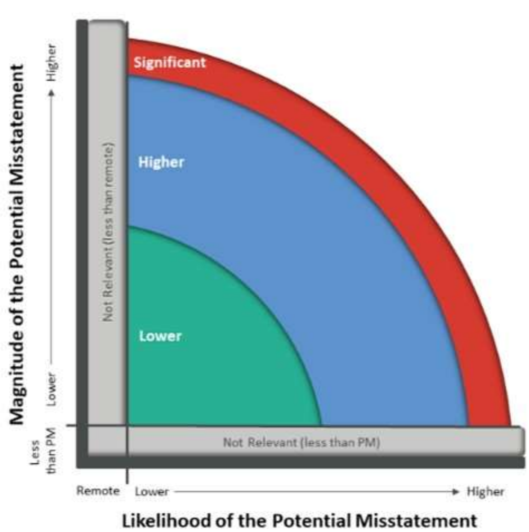
Inherent Risk Factors

Overall Financial Statement Risks	Magnitude of Potential Misstatements	Complexity & Subjectivity	Fraud, Bias, & Related Parties	Changes
To the extent they also affect individual assertions	• Magnitude of potential misstatements (in relation to PM) • Importance of potential misstatements to financial statement users (quantitatively or qualitatively) • Volume of items	• Complex or contentious accounting • Estimation uncertainty, Degree of subjectivity & Management judgment • Model input/output sensitivity • Limitations of data • Significant unusual transactions or transactions outside the normal course of business • Lack of uniformity in the composition of items • Past misstatements, history of errors, or a significant number of adjustments at period end	• Known bias • Aggressive accounting • Susceptibility to fraud • Related-party transactions	• Changes to business, economic, or regulatory environment • Impact of new financial reporting standards • Changes to entity structure

13

Spectrum of Inherent Risk

- There is a spectrum of probability and magnitude
- Lower vs Higher risk
- The highest end of spectrum is called Significant Risk.
- The lowest end is not relevant.



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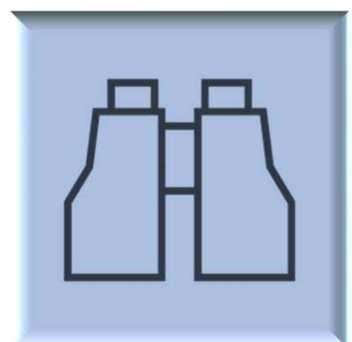
What are Significant Risks?

- Risks at the upper end of the spectrum of inherent risk
- Fraud risks
- Significant unusual related-party transactions

Standback Requirement

- New requirement for Engagement Partner to STANDBACK and reconsider any material COTABDs for which NO RELEVANT ASSERTION has been identified.
- Not impossible, but likely rare.
- What is a COTABD?
  - Class of transaction, account balance, disclosure



Let's Level Set Some Terminology and Phrasing

Relevant Assertion

- Contains a RMM (Low or High)
- Probability of Recurring is More than Remote
- Magnitude of Potential Misstatement is Material

Non-Relevant Assertion

- Probability of Recurring is Remote
- Magnitude of Potential Misstatement is Not Material

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Not Relevant ≠ Not Applicable

Not Applicable = The assertion is not related to a possible misstatement in the audit area

For example, Valuation is not applicable to Cash, if the functional and reporting currency are the same

Not Relevant = The assertion is applicable, but the likelihood of a misstatement is remote **or** the magnitude of the potential misstatement is less than material

For example, Existence is not relevant to an accounts payable balance less than PM because it cannot be overstated by more than PM (although Completeness could be relevant)

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Terminology in the Standard

- **Significant Class of Transaction, Account Balance or Disclosure (Scotabd)**

  - CoT = Income Statement
  - AB = Balance Sheet
  - D = Disclosures - Footnotes or SOCF

- **If there is a relevant assertion, then the COTABD is considered Significant and becomes a Scotabd**
  - **So what…why do I care about this?**

19

19

Terminology

- **Why do I care about a Scotabd?**
  - **A process understanding is required for any Scotabd**
- **Significant Risk - a risk at the upper end of the spectrum of risk**
  - **Fraud**
  - **Significant Unusual Related Party transactions**
- **A significant risk RMM triggers**
  - **Evaluating Design and Determining Implementation**
  - **Test of details (substantive analytics alone not sufficient unless TOC)**

20

20

Terminology NOT in the Standard

- Walkthrough
- You can call anything you want a walkthrough, but to avoid confusion, today, we will not use that term (or we will try not to use it)
  - Process Understanding
  - Evaluation of design and implementation
- **CONFIRM WHAT YOU MEAN AND USE CONSISTENT TERMINOLOGY AT YOUR FIRM – don't let people invent their own language or be lazy with terminology – watch out for direct hires, they will bring with them old firm methodology and terminology**

"Maximum" Control Risk Assessment

Assess control risk at "maximum level" when identified controls are:

Not effectively designed and/or implemented	Not tested for operating effectiveness

Understanding and evaluating design of identified controls may impact nature and timing of further audit procedures **but not extent**

Tests of controls required when substantive procedures alone are not sufficient

Control risk is assessed such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk

If CR is Set at the Maximum

- Then IR is your RMM.
- Then IR is the most important arbiter of your procedures and approach.
- Then IR assessment drives quality and efficiency.
- IR and materiality (and the benchmark used) are critical planning documents.

- Do you need to document your IR assessment rationale? If so, how much is enough?

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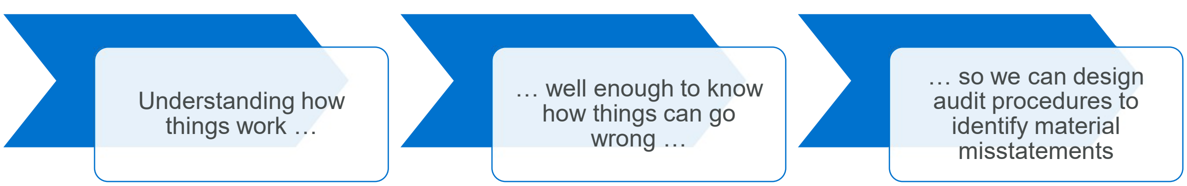
Why Obtain an Understanding of Internal Controls?



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Process Understanding

- For any SCOTABD a process understanding is required.
- This is likely a process memorandum received from the client and may (or may not) include descriptions of process and controls.
- Inquiry is sufficient for the understanding.
- MUST at least include the relevant assertion(s) but likely included almost all activities within a cycle or a process within that cycle.
- What is the purpose?
  - To confirm your risk assessment, or said a different way, to inform you about risk assessment.
  - Consider if you have components (coming later) that also need a process understanding.

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Evaluating Design & Implementation (D&I)

- **Evaluating design** involves consideration of whether the identified control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. **Determining implementation** involves establishing that the control exists, and that the entity is using it.
- Must be more than inquiry
  - Likely the SAME memo used for the process understanding
  - Must include the relevant assertion

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When are you **required** to evaluate D&I?

- Controls over **significant risks** (e.g., improper revenue recognition, management override of controls)
- Controls over **journal entries** (management override) and other adjustments
- Controls for which there is a plan to test OE (e.g., **planned control reliance** or **substantive procedures alone are not enough**)
- Other controls based on professional judgment

Include general IT controls in D&I to address risks arising from the use of IT (coming next)

27

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What Are Risks Arising from the Use of IT?

- Susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes.
- Consider risks related to:
  - How the entity manages **access**, including privileged access
  - How the entity manages program or other **changes**
  - How the entity manages IT **operations**, including batch or job scheduling
- Should include a PROCESS UNDERSTANDING for all applications with a relevant assertion…
  - GL system, lease accounting software, excel spreadsheet, SOC, etc.
- Should be EVALUATED for D&I when another relevant assertion's KEY CONTROL relies on an IT control to "work"

General IT controls are identified based on the risks arising from the use of IT; they need not be identified for every IT system

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Recap: What's the Sequence for Risk Assessment

- Identify/assess risk of material misstatement (WCGW)
- Categorize the level of risk of material error from remote (not relevant) to the highest level of risk (significant)
- The presence of a relevant assertion creates Scotabd
- The presence of a Scotabd creates a need for a Process Understanding including ITGCs – generally a cycle memorandum that captures at least the relevant assertion(s)
  - The memo helps confirm the RMM and may lead to changes
- If the relevant assertion is a Significant Risk assertion convert the Process Understanding into D&I – same cycle memo but with KEY controls over the assertion with the significant risk evaluated through reperformance of at least one
- If D&I relies on IT to work, then convert ITGC understanding into D&I
  - Generally we see one control related to access, and one control related to operations or changes IF applicable.

29

QUESTIONS ON RISK ASSESSMENT?

30

ESTIMATES
SAS 143

31

Accounting Estimates

What is an accounting estimate?

An amount for which the measurement is subject to estimation uncertainty.

What is estimation uncertainty?

The susceptibility of an estimate to an inherent lack of precision in measurement. It’s an estimate that may be hard to pin down or can vary widely or by a material amount. Estimation uncertainty can be small or large and impacts risk and the nature and extent of evidence needed.

32

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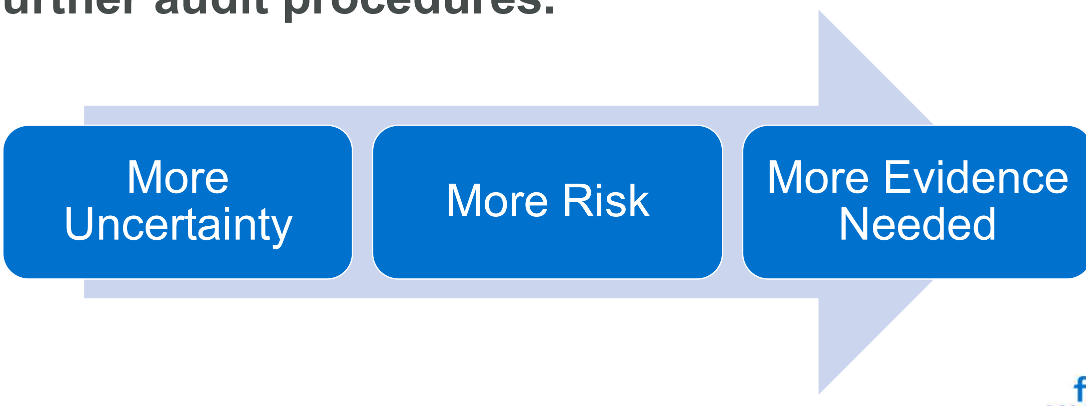
Estimation Uncertainty

As the estimation uncertainty increases --- increase your risk assessment procedures and further audit procedures.



33

33

Professional Skepticism and Estimates

Professional skepticism increases as the estimation uncertainty rises

Complexity, variability and uncertainty can hide/disguise bias.

As estimates become more complex, internal controls may also increase or change

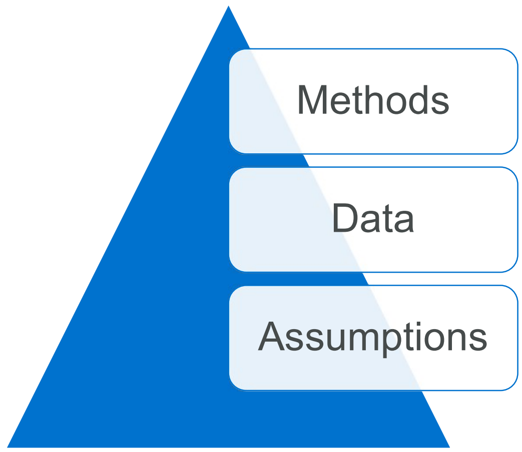
Careful about your evaluation of the design and implementation of those controls.

34

34

Reasonableness of Estimates

Understand how the estimate is created.



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Methods

In computing an allowance for credit losses, the client may incorporate the following for the estimate (along with a reasonable supportable forecast of future losses, if any):

- 20% of receivables outstanding for more than 60 days
- 60% of receivables outstanding for more than 90 days
- 90% of receivables outstanding for more than 120 days

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Data

What data is being used to validate the assumptions? Perhaps a history of writeoffs, and an aged receivable listing. Such a listing breaks receivables into aging categories.

- Do you know the listing of writeoffs is accurate? Do you know the aging is accurate? What if the data is 3rd party data? How do you know it is accurate?
- Is the data relevant – all things considered? That is, if a pandemic has occurred, is this the data you would use to calculate the reserve?

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Assumptions

The client has assumed that there are no indicators that the CECL reserve should be altered for changing economic conditions or industry/company conditions and that history is the best indicator of the CECL reserve.

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Steps to Audit an Estimate

- **Perform risk assessment**
- Identify and assess the risk of material misstatement
- Respond to the risk

Risk assessment:

- **Consider the entity and its environment**, consider the following:
  - Framework
  - Typical estimates
  - Other external factors, such as regulatory

Understand the Process

- Identify the estimate's methods, assumptions, and data sources
- How does management determine the range of potential measurement outcomes?
- How does management address the estimation uncertainty?
- What are the control activities relevant to the estimate?
- Does management review prior estimates and the outcome of those estimates?

What Else Does the Auditor Do?

The auditor should

- retrospectively review the prior estimate to determine if, based on hindsight, if that estimate method is correct for the current year or if adjustments need to be made to the method, the assumptions or the data and
- consider if specialized skills or knowledge are needed

41

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How to Respond to RMM

Link the procedures performed to the specific risks and magnitude of the risks identified

- Test of details
- Substantive analytic
- Both
- Test of controls
- Use of specialist
- Evaluation of their specialist

Method, assumptions, data

- Often auditors forget to corroborate the data and is a common peer review comment

More risk, more evidence needed!

42

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What Needs to be Documented - Recap

Documentation should include the following:

- The auditor's **understanding of the entity and its environment, including internal controls related to estimates.**
- **Linkage of further audit procedures** with the risks of material misstatement at the assertion level.
- **Auditor's responses when management has not taken appropriate steps to understand and address estimation uncertainty including results of PY estimates**
- **Indicators of possible management bias** related to estimates.
- **Significant judgments related to estimates and related disclosures** in light of the reporting framework.

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QUESTIONS ON ESTIMATES?

44

GROUP AUDITS
SAS 149

45

Group Financial Statements (Revised Term)

- Financial statements that include the financial information of more than one entity or business unit through a consolidation process (including an equity method investment)

Extant Definition

Financial statements that include the financial information of more than one component. The term group financial statements also refers to combined financial statements aggregating the financial information prepared by components that are under common control

Revised focus on consolidation process (not components)

46

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Consolidation Process (Revised Concept)

- A consolidation process includes one or more of the following:
  - Consolidation, proportionate consolidation, inclusion, or an equity method of accounting
  - The presentation in combined financial statements of the financial information of entities or business units that are under common control or common management
  - The aggregation of the financial information of entities or business units such as branches or divisions

Based on aggregation of financial information of more than one entity or business unit

47

47

Component (Revised Term)

- An entity, business unit, function, or business activity, or some combination thereof, determined by the group auditor for purposes of planning and performing audit procedures in a group audit

Extant Definition

An entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements

Focus on group auditor's determination based on work to be performed (not solely financial reporting framework)

48

48

Group Auditor (New Term)

- The group engagement partner and members of the engagement team other than component auditors
- The group auditor is responsible for the following:
  - Establishing the overall group audit strategy and group audit plan
  - Directing and supervising component auditors and reviewing their work
  - Evaluating the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the group financial statements

Replaces the extant term and definition of "group engagement team"

49

49

Component Auditor (Revised Term)

- An auditor who performs audit work related to a component for purposes of the group audit
- A component auditor:
  - Is now an engagement team member (SAS No. 146)
  - May be from a network firm, a non-network firm, or the group auditor's firm (for example, another office)
- The group engagement team is no longer considered a component auditor

A component auditor is a resource not an information source (SQMS No. 3)

50

50

Referred-to Auditor (New Term)

- An auditor who performs an audit of the financial statements of a component to which the group engagement partner determines to make reference in the auditor's report on the group financial statements
- A referred-to-auditor is:
  - No longer a component auditor
  - Not an engagement team member (SAS No. 146)

A referred-to auditor is an information source and not a resource (SQMS No. 3)

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Aggregation Risk (New Term)

- The probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole
- Generally, aggregation risk increases as the number of components at which audit procedures are performed separately increases

Considered in determining component performance materiality

52

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Assuming **Responsibility** vs. Making Reference

Extant AU-C section 600 terminology	SAS No. 149 terminology
Assuming responsibility	• Being involved in the work of component auditors • When component auditors are involved
Making reference	• Making reference (no change)

SAS No. 149 continues to allow making reference, while ISA 600 (Revised) continues to prohibit making reference

53

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Other Considerations

- Audit Response
- Component Materiality
- Communications with Other Auditors
- Quality Management (QM) Considerations (SAS No.146)

54

Audit Response

- Eliminates the term "significant component" (including broader concept of "financial significance")
- Components now evaluated and selected for testing considering:
  - Nature of events or conditions that may give rise to risks of material misstatement
  - Disaggregation of significant classes of transactions, account balances, and disclosures
  - Assessed risks of material misstatement of group financial statements
  - Whether sufficient appropriate audit evidence is expected to be obtained
  - Nature and extent of misstatements or control deficiencies identified in prior periods
  - Nature and extent of commonality of controls across group and, if so, how the group centralizes financial reporting activities

Component determined based on group audit approach; determination is based on professional judgment

55

55

Audit Response

- Eliminates required, prescriptive audit responses based on component significance (e.g., audit of component)
- Responses based on and responsive to assessed risks and might include:
  - Further audit procedures on entire financial information of component (e.g., audit of component)
  - Further audit procedures on one or more classes of transactions, account balances, or disclosures
  - Specific further audit procedures (e.g., procedures designed by group auditor)
- Other considerations
  - Introducing an element of unpredictability
  - Operating effectiveness of controls

Component auditors may be involved in designing and performing further audit procedures

56

56

Component Performance Materiality (PM)

- Determined by group auditor for components on which the group or component auditor will perform audit procedures (not required for referred-to auditors)
- Addresses aggregation risk
  - Individual component PM lower than group PM
  - Aggregate of component PM may exceed group PM
- Misstatement threshold for component financial information does not exceed group misstatement threshold
- Document basis for determination of component PM and misstatement threshold

Aggregation risk increases when procedures are performed separately on component financial information

57

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Communications with Component Auditors

- Group auditor communicates various responsibilities and expectations, including work to be performed
- Component auditor communicates:
  - Financial information on which procedures were performed
  - Whether work requested by group auditor was performed
  - Whether they complied with ethical requirements, including independence
  - Not previously identified related party relationships and transactions
  - Instances of noncompliance with laws and regulations
  - Corrected and uncorrected misstatements above threshold
  - Indicators of possible management bias
  - Deficiencies identified
  - Fraud or suspected fraud
  - Significant matters communicated to component management
  - Other matters, including exceptions noted in written representations
  - Overall findings and conclusions

Effective two-way communication is critical and helps set expectations

58

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Communications with Referred-to Auditors

- No significant changes in communications
  - Ethical requirements, including those related to independence
  - Cooperation with group auditor
  - Related party relationships and transactions
  - Permission to name referred-to auditor in the group auditor's report (if applicable)
  - Conclusions (financial information reported on, compliance with ethical requirements, auditor's report)

Exhibit A highlights the relevant requirements related to component auditors and referred-to-auditors

QM Considerations (SAS No. 146)

- Component auditor now part of engagement team
- Enhanced group engagement partner responsibilities for direction and supervision, and review of work
- Enhanced focus on the following:
  - Competence and capabilities
  - Relevant ethical requirements, including independence
  - Understanding and compliance with group audit firm's policies and procedures
- May involve communications or representations related to component auditor's system of quality management

Quality risks and responses may be different for engagement team members that are component auditors

Equity Method Investments

Investments accounted for using the equity method of accounting are considered components. SAS No. 149 provides enhanced requirements and guidance related to equity method investments.

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Using Audited Financial Statements

Audit Evidence	Audit Response
Audited financial statements provide sufficient appropriate audit evidence	• Further audit procedures may not be necessary • Consider whether to make reference
Audited financial statements do not provide sufficient appropriate audit evidence	• Perform additional audit procedures • Be involved in work performed by component auditors

Determine whether to use audited financial statements of equity method investment as audit evidence

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Equity Method Investment Considerations

- Significance of investment and materiality of transactions
- Professional competence or independence of investee's auditor
- Significant differences in fiscal year-ends, accounting principles, or auditor's report dates
- Significant differences between the carrying amount on the group financial statements and the underlying equity in net assets on the noncontrolled entity financial statements
- Changes in ownership of noncontrolled entity or changes in conditions affecting use of the equity method

QUESTIONS ON GROUP AUDITS?

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65