Internal Inspection Practice Aid

Addressing Non-Compliance with AU-C 315 and 330

Overview[1]

In reviewing an engagement, the individual performing the inspection ("the reviewer") seeks to determine if the auditor who performed the engagement ("the auditor") has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and support the auditor's opinion.

To reduce audit risk to an acceptably low level, the auditor should obtain an understanding of the client and its internal control in order to identify and assess the client's risks in accordance with AU-C 315. The auditor should then design or select audit procedures that respond to those risks in accordance with AU-C 330.

When reviewing an audit engagement, if the reviewer determines that the auditor failed to comply with AU-C 315 or 330 such that audit risk was not reduced to an acceptably low level, the reviewer should conclude that the audit was not conducted in accordance with GAAS and that the auditor failed to obtain sufficient appropriate audit evidence to support the audit opinion.

Evaluating if AU-C 315 and 330 Requirements are Met

When determining if the requirements of AU-C 315 and 330 were met, the reviewer should consider the following questions:

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[1] This practice aid is intended to help auditors consider the requirements of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, when performing inspections as part of a firm's monitoring procedures. This publication is an "other auditing publication" as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, Professional Standards). Other auditing publications have no authoritative status; however, they may help you understand and apply certain auditing standards.

In applying the guidance included in an "other auditing publication," the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved or otherwise acted on by any senior technical committee of the AICPA.

Did the auditor evaluate the design and implementation of controls relevant to the audit?

AU-C 315.14 states,

> *When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel.*

Reviewers may encounter auditors who think evaluating control design and determining if controls exist are one and the same. This is not an appropriate reading of the standard. Auditors are expected to:

- Consider what could go wrong as the client prepares their financial statements
- Identify the controls meant to mitigate those financial reporting risks
- Evaluate the likelihood that the controls are capable of effectively preventing or detecting and correcting material misstatements

This is a high bar, and only after all three of these steps have been completed has the auditor evaluated the design of the client's controls in conformity with AU-C 315.14.

Some auditors may indicate that the requirements of AU-C 315.14 do not apply to their client because their client has no controls. This is a false assumption. While an entity may not have documented controls, some controls always exist. Examples for smaller entities include monitoring of financial results by management; reconciliation of accounts, such as cash, accounts receivable and accounts payable; computer log-in credentials; and communications from management to employees about the importance of properly recording transactions.

Other auditors may suggest that they did not evaluate the design and implementation of controls relevant to the audit because they are not relying on the operating effectiveness of the controls. Regardless of whether the auditor is relying on operating effectiveness, the nature of control risk can only be ascertained by evaluating the design and implementation of the control. Without understanding the nature of the risk, the auditor cannot design an appropriate response.

Did the auditor identify one or more significant risks?

Significant risks are risks of material misstatement that require special audit consideration. These are typically nonroutine transactions that require significant judgment, such as the application of new accounting principles or valuations of hard-to-value assets.

Virtually every audit, including audits of small- and medium-sized entities, has at least one significant risk. This is because, under AU-C 240.27, risks of material misstatement due to fraud should be treated as a significant risk, and there is a presumption on virtually every audit that revenue recognition is a risk of material misstatement due to fraud. As such, a failure to detect any significant risk almost always represents a failure to comply with AU-C 315.28.

Was risk assessed at the financial-statement and relevant assertion levels?

During the inspection, a reviewer may encounter audits where the risks of material misstatement are assessed at the account level only rather than at the relevant assertion level. For example, the auditor might conclude cash has a low risk of material misstatement, while the risk relative to accounts receivable is high. This represents non-compliance with AU-C 315.26. But why?

The assessment of the risks of material misstatement is not performed at the account level. This is because each account has numerous relevant assertions, each of which may have different levels of risk that require different audit responses.

Some practitioners confuse account-level risk with financial statement-level risk. Financial statement-level risks are not risks limited to one account balance, but rather, risks that are pervasive to the financials. For example, one financial statement-level risk would be a lack of expertise in the client's accounting department, which would affect numerous accounts and assertions. Financial statement-level risks require an overall response, such as assigning more experienced audit staff or incorporating additional elements of unpredictability.

Does the risk assessment reflect the nature and degree of risk?

Reviewers should consider the appropriateness of the risk assessment based on the auditor's understanding of the entity. For example, consider the valuation assertion for cash. If inherent risk is "low" and control risk is "high," some auditors may default to "moderate" risk of material misstatement. However, before reaching this conclusion, the auditor should consider the nature of the risks. If the client has no controls in place to ensure their obligations are properly recorded, an assessment of "high" risk of material misstatement may have been more appropriate. If an assessed risk of material misstatement does not appear appropriate, the auditor may have failed to comply with AU-C 315.27.

Is there a clear linkage between risk assessment and response?

Many auditors of smaller clients appear to be documenting their risk assessment in accordance with AU-C 315, but performing audits with little regard to the results of that assessment. This is often due to overreliance on standardized, third-party practice aids.

While standardized practice aids can be valuable tools, they must be used as intended to be effective. Even if an auditor uses standardized aids, they are still required to link the procedures they perform back to their risk assessment.

Reviewers should consider the linkage between the risk assessment and the auditor’s procedures, and they should determine whether the procedures are responsive to the client’s financial statement- and assertion-level risks. If the auditor’s procedures are not responsive to one or more risks, the auditor has failed to comply with AU-C 330.06.

Were the audit programs modified for significant risks?

AU-C 315.04 indicates significant risks require special audit consideration, which means consideration above and beyond what a standardized audit program would address. This means the auditor should be modifying their audit programs to address these risks. As such, if an auditor has not tailored their standard audit approach to address significant risks, it is likely that they have failed to comply with AU-C 330.22.

If AU-C 315 or 330 Requirements are Not Met

Conclude on the Review of the Engagement

If the reviewer determines that the requirements of AU-C 315 or 330 were not met such that audit risk was not reduced to an acceptably low level, the reviewer should conclude that the audit was non-conforming (i.e., was not performed and/or reported on in conformity with applicable professional standards in all material respects). The reviewer should document this conclusion in the monitoring documentation.

AU-C 585 Consideration

If the engagement subject to review is deemed non-conforming, the firm should consider its obligations under AU-C 585, *Consideration of Omitted Procedures After the Report Release Date*.

The firm should investigate the issue in question and determine what action, if any, should be taken, including actions planned or taken to prevent unwarranted continued reliance on its previously issued reports.

The firm should then document the results of its investigation, including parties consulted and actions planned or taken or its reasons for concluding that no action is required.

Systemic Evaluation

The reviewer should seek to understand the underlying cause of the finding. Gaining this understanding will involve analysis of the firm's quality control policies and procedures and discussion with the firm's partners and/or personnel.

When audit procedures or audit evidence were not documented, these discussions should address whether the procedures were performed but not documented as required or whether the procedures were not performed at all. Additionally, the reviewer should ascertain whether the personnel understood the requirements of AU-C 315 and 330 and should address the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level.

Once the underlying cause of the matter is understood, the firm should take appropriate remedial action to address it.