

Center for Plain English Accounting

AICPA's National A&A Resource Center

Accounting & Auditing Practice Risk During the Pandemic - Part 2

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Introduction

As firms begin to plan their 2020 year end accounting and auditing (A&A) engagements, the CPEA believes now is an excellent time to be thinking about practice risk and what can be done to reduce that risk, especially during the current pandemic.

In [part 1](#) of this CPEA report series, we discussed the first line of defense that CPEA firms should take to help mitigate its A&A practice risk (AAPR). That first line of defense consists of a strong and effective system of quality control. In this report (part 2), we will delve into what engagement teams can do to reduce A&A practice risk, when performing audit (or examination) engagements.

As a premise, if an auditor can reduce audit risk, A&A practice risk also will be reduced. Therefore, this report will address some steps an engagement team can take to reduce audit risk. Specifically, this report will address:

1. Audit evidence and the impact of professional skepticism
2. The auditor's responsibilities with respect to risks of material misstatements, whether from fraud or error
3. The auditor's communication requirements

While managing A&A practice risk is one of the most important responsibilities of partners and staff, the topic of risk management is not often discussed among assurance partners, let alone with engagement staff. While nothing this report addresses is new, we believe these are concepts that need to be repeated and reinforced, especially during the pandemic where more and more engagement teams are remotely working and remotely performing assurance services.

To have a common understanding of terms, we will use the following definitions for the purpose of this report:

Accounting and Auditing Practice Risk (sometimes referred to as litigation risk) – is the risk that a claim will be filed against the firm claiming monetary damages. This is typically a threatened or actual lawsuit brought against the firm by a client's owner, investor (or potential investor), a donor or a creditor claiming that they lost money due to the firm's malpractice in conducting an A&A engagement.

Accounting and Auditing Practice -- a practice that performs engagements, which are audit, attestation, compilation, review, and any other services for which standards have been promulgated by the AICPA's Auditing Standards Board (ASB) or the Accounting and Review Services Committee (ARSC).

Audit (or Examination) Risk – is the risk that the auditor expresses an inappropriate audit (or examination) opinion when the financial statements (or subject matter) are materially misstated. Audit risk is a function of the risks of material misstatement (RMM) and detection risk (DR).

Risk of Material Misstatement – is the risk that the financial statements (or subject matter) are materially misstated prior to the audit (or examination). This risk consists of two components, inherent risk and control risk.

Detection Risk (DR) – is the risk that procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Professional Skepticism – is an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.

Audit Evidence – is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements.

Fraud – is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit. Although fraud is a broad legal concept, the auditor is primarily concerned with fraud that causes a material misstatement in the financial statements.

Notice

Nothing in this report should be construed as legal advice. This CPEA report is written from my personal perspective based on 25 years of public accounting practice experiences, and 16 years serving as the AICPA's Vice President of Professional Assurance Standards, which included working closely with the AICPA's retired General Council, Rich Miller.

Interrelationship Between A&A Practice Risk and Audit Risk

Audit Evidence and the Impact of Professional Skepticism

Just as we know that a firm cannot reduce its A&A Practice Risk to zero (short of not performing any A&A engagements), so too is it true that an auditor cannot reduce audit risk to zero. The standards (and common sense) inform us that obtaining absolute assurance that the financial statements are free from material misstatement due to fraud or error is impossible (therefore, the audit report indicates that the auditor obtained reasonable assurance). One reason why this is true is because most audit evidence, obtained by the auditor, is persuasive rather than conclusive.

While it is impossible to reduce audit risk to zero, it, nevertheless, is important to understand that GAAS requires an auditor to reduce audit risk to an appropriately low level. Not to get too deep into audit theory, but an auditor needs to understand that obtaining reasonable assurance and reducing audit risk to an appropriately low level are two sides of the same coin.

AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, specifically AU-C 200.19, sets forth an audit requirement that is quite simple and straightforward. That requirement indicates:

To obtain reasonable assurance, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

Let's explore AU-C 200.19 in more depth since this requirement gets to the heart of what an audit requires. And by doing so, I think we can better understand how an auditor can reduce A&A Practice Risk by reducing audit risk.

By definition, audit risk is a function of the RMM and DR. As we know, an auditor cannot control RMM. RMM is evaluated by the auditor (risk assessment), and based on that evaluation, the auditor decides upon the nature, timing, and extent of procedures to

perform in order to reduce DR so as to reduce audit risk to an acceptably low level. The lower an auditor drives DR the lower the audit risk.

Therefore, an auditor should always focus on DR, as that is the risk within the auditor's control. Reducing DR, reduces audit risk, which in turn, reduces A&A practice risk.

In my role as Vice President of Assurance Standards for the AICPA, which included two years as Vice Chair of the International Auditing & Assurance Standards Board (IAASB), I had the opportunity to review peer review and inspection reports from around the globe. A common finding that appeared more than any other findings was the lack of audit evidence obtained in key audit areas. That lack of audit evidence included the contention by the peer reviewer or inspector that auditors too often relied only on corroborative evidence while ignoring (or not even looking for) contradictory evidence.

What this means in plain English, is that an auditor who does not obtain persuasive evidence is at risk for issuing the wrong audit report. When reasonable assurance has not been obtained, a firm's audit risk and AAPR increases. Why? Because there is a greater likelihood (or risk) for a material misstatement to exist and not be detected. Therefore, a user who relied on an unmodified auditor's report and who is damaged by financial statements that are materially misstated, will claim that the audit team did not meet its standard of care.

Going back to our definition, the more persuasive audit evidence that an auditor obtains, the lower the detection risk, the lower the audit risk and the lower the AAPR. So why do engagement teams not obtain persuasive audit evidence? One major reason is that some auditors believe corroborative evidence alone is sufficient appropriate evidence.

As explained in generally accepted auditing standards (GAAS) (AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, and AU-C 500, *Audit Evidence*), sufficiency and appropriateness of audit evidence are interrelated. Together they affect the persuasiveness of audit evidence. The auditor's conclusion about whether sufficient appropriate audit evidence has been obtained in accordance with GAAS runs to both the financial statement level as well as the relevant assertion level. GAAS requires the auditor to obtain more persuasive audit evidence when the assessment of RMM (inherent or control) is higher. For example, more persuasive audit evidence is needed to respond to significant risks. Persuasiveness, therefore, relates to the auditor obtaining appropriate audit evidence that is sufficient for the auditor to draw reasonable conclusions.

Practice Note: When the standard uses the phrase "more persuasive audit evidence" the term "more" does not run to quantity but rather the quality or appropriateness of the audit evidence. Accordingly, the higher the risk, the greater the quality of the evidence that is needed to make sure that DR has been reduced to a low level.

It is impossible to discuss persuasive audit evidence without also discussing professional skepticism. Earlier it was mentioned that the most cited finding from peer review and inspection reports was the lack of audit evidence. When these peer reviewers or inspectors described the root cause for failure to obtain persuasive evidence, the report frequently cited the lack of professional skepticism.

Professional skepticism includes being alert to the following:

- Audit evidence that contradicts other audit evidence
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence
- Conditions that may indicate possible fraud
- Circumstances that suggest the need to perform audit procedures in addition to those required by GAAS

Professional skepticism is critical to the assessment of audit evidence. This includes searching for and questioning contradictory audit evidence, the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. Professional skepticism also includes consideration of the sufficiency and appropriateness of audit evidence obtained in light of the circumstances.

For example, in the case of a significant risk due to management estimates, when fraud risk factors exist and a single document, that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount, the auditor most likely has not obtained persuasive audit evidence. While that document may provide confirmation evidence, the auditor still is obligated to search for and to evaluate disconfirming or contradictory evidence. Confirming evidence, by itself, may not be persuasive.

The take away from the GAAS audit evidence requirements mean that, if the engagement team is not searching for and evaluating disconfirming and contradictory information as well as corroborative evidence, then the standards indicate that the auditor has not exercised professional skepticism and has not obtained persuasive (sufficient appropriate) audit evidence. And without sufficient appropriate audit evidence, the auditor has not reduced audit risk to an acceptably low level and, by definition, has not obtained reasonable assurance.

Practice Pointer

As Vice Chair of the IAASB, we conducted roundtables around the globe asking auditors what they felt “sufficient appropriate audit evidence” meant and also what they thought “persuasive audit evidence” meant? It was interesting, but not surprising, that auditors had a view that persuasive audit evidence was a higher or greater bar relative to the term sufficient appropriate audit evidence. They felt that obtaining persuasive audit evidence generally would take more time and effort than what they were presently doing. Almost to a person, they were surprised when we pointed out that the auditing standards equate the two terms. If you’re not equating the two terms, or if you do not believe that members of your audit engagement teams equate the two terms, I would strongly suggest that you have a training program prior to planning and performing year end 2020 engagements in order to educate your engagement members on the requirements.

I think it is fair to say that financial statements, even for smaller audit clients, contain far more estimates than in years past when “historical cost” was a more acceptable basis for recording a transaction. If, in auditing an estimate, an auditor stops auditing an account or assertion once they have what they believe to be information that supports the client’s estimate, the auditor only has obtained corroborative evidence. What if the assumptions used in preparing the estimate are unreasonable or information can be found by the auditor that contradicts the assumptions? In that case, the auditor has failed to obtain persuasive (sufficient appropriate) audit evidence and has failed to reduce audit risk to a low level. Consequently, the engagement team has allowed the firm’s AAPR to increase. Not only is persuasive audit evidence needed to verify an account or assertion, but persuasive audit evidence is necessary when auditing the notes to the financial statements.

Another issue that can come into play when auditing smaller audit clients, is when the audit team performs a nonattest service by “assisting” the client in preparing the estimate. This situation puts more stress on the engagement team because the engagement team will need to evaluate the client’s ability to take responsibility for the estimate, which is required in order to maintain independence; and, also because the staff member who “assisted” in preparing the estimate will have his or her own biases in determining the assumptions that go into making the estimate. And, when that same staff member might be asked to audit that estimate, that staff member, who is auditing their own work, is susceptible not only to confirmation bias but also anchoring bias.

CPEA Observation: Anchoring bias is a bias where an individual depends too heavily on an initial piece of information (considered to be the "anchor") to make subsequent judgments during decision making. In our example, the staff member who "assisted" in calculating the estimate created the anchor amount. Once the value of this anchor is set, all future estimates are discussed in relation to the anchor. Audit evidence that aligns with the anchor tends to be relied on, while evidence that is more dissonant or less related tends to be dismissed. When this is the case, we believe that the engagement team should have its evidence closely reviewed by another partner or staff member who does not have the same level of bias as the staff person who performed the nonattest service and then audited the account.

While not discussed in [part 1](#) of this series, the quality control (QC) standards require firms to have policies and procedures in place for when an Engagement Quality Control Review (EQCR) needs to be performed. Firms should be aware of situations where the risks of staff and partner biases are greater and include those situations for when an EQCR is performed. Even if a full EQCR is not performed, a second partner or manager can at least perform a second review of these areas to provide the firm with some assurance that appropriate auditing procedures were performed and persuasive evidence, not just corroborating evidence, was obtained.

The Auditor's Responsibility for Fraud

In February 1997, the ASB issued Statement on Auditing Standards (SAS) 82, *Consideration of Fraud in a Financial Statement Audit*. This standard was issued in our attempt to make clear that an auditor has a responsibility for planning and performing an audit to detect material misstatements, whether caused by fraud or error. In October 2002, SAS 99, *Consideration of Fraud in a Financial Statement Audit*, was issued because the guidance in SAS 82 did not seem to be "clear enough." In addition to clarifying the auditor's responsibilities, SAS 99 also added more requirements (e.g. the fraud brainstorming session). Finally, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, was clarified in October 2011 to again make clear that an auditor does have a responsibility to plan and perform an audit to detect material misstatements, whether caused by fraud or error.

Recently, there were two events that give me pause and concern. The first event was an article in the Wall Street Journal, Saturday October 17, 2020 to be exact. In that front-page article, it described four financial statement scandals. It went on to describe in detail the way that each of these four alleged frauds were carried out. The article also indicated:

The firm also recently said that auditors must play a bigger role in detecting fraud at companies, which would represent a U-turn in an industry that for long has denied that was part of its job.

The second event came during the December 2020 CPEA webcast in which we received a few questions asking whether fraud detection was part of an audit?

AU-C 240.05 indicates:

An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Due to the inherent limitations of an audit, an unavoidable risk exists that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS.

So why do these events give me pause and concern? Because it seems that after 20+ years of having a fraud standard, some members of the profession still are not sure that it is part of their job as an auditor.

If there is any one event that may guarantee a claim against your firm, it is an event where a material fraud was committed and the fraud was not detected by the auditor. Also, keep in mind, a business owner and a juror likely will have a far different view of “materiality” than that of the engagement team. So, if audit teams know they have a responsibility to comply with AU-C 240, why is the possibility of fraud not given the time and attention that it deserves?

In my view, it is usually because:

1. The engagement team is overconfident in their belief that their client (including the owner and other employees) would not commit a fraud (this is particularly true when an employee is a former employee of the firm)
2. The engagement team does not believe that any theft would be material to the financial statements
3. The engagement team identifies a potential fraud risk but fails to follow through on the risk because the team does not exercise professional skepticism, or the firm believes that its standard audit procedures are appropriate to detect material misstatements

Practice Pointer

One of the provisions of SAS 99 was the requirement for the engagement team to perform a brain storming session on how a fraud might be committed. The standard drives the engagement team to identify potential fraud risks and then evaluate what client controls are in place to mitigate those potential risks. Then the auditor is required to determine whether the risk is a significant risk. If a significant risk, the auditor should design and perform further audit procedures where the nature, timing, and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level (as per AU-C 330). The idea of further audit procedures does not include typical or normal auditing procedures performed on all audits.

Ask yourself, when is the last time you tailored an audit program for a specific fraud risk for a specific audit client?

While I heard that many engagement teams found brainstorming to be an exciting exercise in the earlier years of the standard, the requirement seems to have become routine where effective brainstorming is either not being performed or fraud risks that are identified, are being downplayed (shot down) by the engagement partner. Not only is the “tone at the top” important at the firm level, but also within the engagement team. When staff members see the engagement partner not taking the brainstorming seriously, or sees the engagement partner consistently downplaying fraud risks, that tone carries through and the staff stop taking the responsibility seriously.

During this pandemic, where engagement planning is happening via zoom or other virtual tools, it is going to take exceptional effort on the part of engagement teams to spend the time necessary to properly brainstorm the risks from fraud and to work through situations where financial statement fraud might occur, either as a result of theft or intentional misstatement.

Regardless of how your engagement planning takes place, remember it is your responsibility to plan for and to obtain persuasive evidence that the financial statements are free from material misstatement whether from fraud or error. And remember, even an immaterial fraud likely will result in a claim against the firm.

The Expectation GAP

As discussed earlier, even if an engagement team performs a “perfect” audit, that does not guarantee that the firm will not be sued for audit malpractice. But if a client believes that the firm performed a thorough and effective audit, it follows that the client is less likely to file a lawsuit against the firm.

Therefore, we need to appreciate and understand that managing a firm’s AAPR is going to be impacted by what the client believes, not whether the engagement team complied with GAAS. This difference between the client’s and users’ expectations for an audit and the auditor’s expectations is referred to as the “expectation gap.”

The expectation gap has been an issue that auditors and standard setters have worked to close for many years. Unfortunately, there is no silver bullet. So, how do engagement teams plan and perform their audits in a way that reduces this gap? For starters, auditors need to believe that an audit is NOT A COMPLIANCE EXERCISE and approach the audit from a user’s perspective.

Generally, the expectation gap is referred to as the gap between what the client and user think are the responsibilities of the auditor in performing an audit versus what the auditor believes are their responsibilities in performing an audit. Setting client expectations and, thereby, closing the expectation gap, is more often a function of an auditor’s communications (oral and written) with the client than with the performance of auditing procedures. The performance of auditing procedures is viewed by many smaller unsophisticated clients as something that just happens in the “black box.”

Therefore, auditors need to manage client expectations by having clear and plain communications about:

1. The terms of the engagement, including who is responsible for what
2. What is required and expected by those charged with governance (which may just be the owner in a small business)
3. The responsibility for and the consequences of internal control related matters identified in the audit

Practice Note: I have served on various audit committees and have been surprised at the casualness of each firm’s presentations of these communication responsibilities. Each firm has tended to brush past many important topics and has merely presented boiler plate documents that did little to close any expectation gaps; although, I am sure they checked off their audit programs believing they complied with GAAS.

As chair of the audit committee, auditors would ask me some probing questions, such as:

1. What I felt accounting materiality should be

2. What those charged with governance have done to evaluate the entity's fraud risks
3. If management or governance did identify a fraud risk factor, what controls did we put in place to mitigate that fraud risk

Also, I have been surprised by the lack of internal control related matters reported especially when I knew the organization had some weaknesses and those weaknesses should have been identified by the audit team. Further, not once did an audit partner volunteer to hold a training session for the other audit committee members to better educate them on the nature of an audit and costs benefit decisions that go into planning an audit.

Rather, the firms' presentation of the engagement letter (at the start of the engagement) and the required communications with those charged with governance and internal control matters (at the end of the engagement) were brushed over. It was almost as if they were embarrassed that they had to take up the time of the committee members to explain these matters. This is the type of behavior that does nothing to close the expectation gap. While the firm can check off their audit programs that they complied with these procedures, I would contend that the firm did not comply with the intent of the standards nor with the importance of why the ASB put these standards into GAAS.

These are important communications in helping to reduce AAPR. My suggestion is that auditors think about these communications from three perspectives:

1. Assume the owner, or those charged with governance, know nothing about an audit. Therefore, do not merely lay an engagement letter in front of them, as it will not be understood. My recommendation is that the engagement team take plenty of time, regardless of how boring you view the task, to make crystal clear the firm's responsibilities versus the entity's responsibilities, especially management's responsibility for its internal control. And make sure you take the time immediately afterwards to document that communication.
2. Take the view that communications (oral and written) will be the difference between winning a lawsuit or losing a lawsuit and paying out big dollars. Not to mention, the possibility of your firm's name being on the front of the Wall Street Journal (or your local newspaper).
3. Carry out these communications not as an advocate for the client but, rather, as a public interest agent whose job it is to be independent and be totally clear and transparent calling out bad news, as well as good. Even if the client might not want to listen (for example when communicating significant deficiencies and material weaknesses) or tries to brush off these communications as unimportant, it is still the auditor's responsibility to deliver and communicate this information.

In closing, your reputation and that of your firm may be riding on how well you communicate and how well you are able to close the expectation gap.

As always, if you have any questions about this report please contact us at cpea@aicpa.org. We at the CPEA stand ready to serve you and to help you make your A&A practice the best it can be.

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