



## Agenda Item 5

### **Omnibus Statement on Auditing Standards—2018 Cover Memo, Summary of Responses and Issues**

#### **Objective of Agenda Item**

To discuss comment letters received in response to the exposure draft of Proposed Statement on Auditing Standards, *Omnibus Statement on Auditing Standards —2018*

#### **Task Force**

Convergence Task Force members are:

- Jan Herringer, Chair
- Bridgett Gyorfi
- Laura Schuetze
- Courtney Drake
- Dan Wernke

#### **Background**

The mission of the Auditing Standards Board (ASB) is to serve the public interest by developing, updating, and communicating comprehensive standards and practice guidance that enable practitioners to provide high-quality, objective audit and attestation services to nonissuers in an effective and efficient manner. The ASB accomplishes this mission in part by developing auditing, attestation, and quality control standards that inspire public trust in the profession. In developing and updating auditing standards, the ASB considers the standards of other standard-setters, such as the International Auditing and Assurance Standards Board (IAASB), the PCAOB, and the General Accounting Office (GAO).

Since the ASB completed its auditing standards clarity project, which clarified generally accepted auditing standards (GAAS) and converged them with the International Standards on Auditing (ISAs) issued by the IAASB, the PCAOB has issued Auditing Standard (AS) 1301, *Communication With Audit Committees*; AS 2701, *Supplementary Information*; and AS 2410, *Related Parties* (AICPA, PCAOB Standards and Related Rules). The release of these auditing standards included conforming amendments to other PCAOB auditing standards. The ASB considered whether these three standards included material that, if included in the requirements

or application material of GAAS, would enhance audit quality for audits of financial statements of nonissuers in an effective and efficient manner.

The ASB reviewed the three PCAOB auditing standards and, for each requirement in a PCAOB auditing standard that the ASB believes does not have an equivalent in GAAS, considered whether an amendment to GAAS was appropriate.

With regard to its evaluation of material from AS 2701 no changes to GAAS are being proposed. Release No. 2013-008, *Auditing Standard No. 17—Supplementary Information Accompanying Audited Financial Statements*, explains that a primary consideration in developing AS 2701 related to the PCAOB’s oversight of brokers and dealers in securities. After consideration of the PCAOB’s objective and evaluating the sufficiency of the procedures and reporting in existing GAAS, the ASB concluded that no amendments to GAAS are necessary.

The proposed SAS, *Omnibus SAS—2018*, proposed amendments to 13 AU-C sections, with the most substantive amendments to AU-C section 260, *Communications With Those Charged With Governance*, AU-C section 550, *Related Parties*, and AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.

The exposure draft of the proposed SAS was issued in November 2017. Comments were due on May 15, 2018.

### **Agenda Materials**

- 5A Proposed SAS, *Omnibus Statement on Auditing Standards—2018*
- 5B Analysis of Responses
- 5C AS 2410 Compared to GAAS
- 5D AS 2410 Conforming Amendments Compared to GAAS
- 5E AS 1301 Compared to GAAS

## Summary of Comments

22 responses were received. Overall, respondents were supportive of the amendments.

1. TIC	TIC
2. Tennessee	TN
3. Cherry Baekert	CB
4. NASBA	NASBA
5. Washington State Auditor	WSA
6. Michigan Office of Auditor General	MI
7. Florida Society of CPAs	FL
8. BDO	BDO
9. Illinois CPA Society	IL
10. Association of Local Government Auditors	ALGA
11. GT	GT
12. Crowe Horwath -	Crowe
13. North Carolina Association of CPAs	NC
14. California Society of CPAs	CA
15. Anders	Anders
16. BakerTilly	BT
17. PwC	PwC
18. EY	EY
19. KPMG	KPMG
20. Laura Lindal	LL
21. DT	DT
22. NSAA	NSAA

The exposure draft of the proposed SAS posed two issues for respondents to consider:

### Issue 1: Significant Unusual Transactions

Respondents were asked to provide their views on the use of the defined term “significant unusual transactions” instead of the phrase “significant transactions that are outside the normal course of business or that otherwise appear to be unusual” consistently throughout GAAS.

All respondents were supportive of the use of term “significant unusual transactions”. One respondent pointed out the need for additional conforming changes in other AU-C sections.

One respondent<sup>1</sup> requested that the term be included in the definitions section of each section in which it appears, and one respondent<sup>2</sup> believes that when the term is used, it should be footnoted to refer to the definition. The convention is to define a term in the first AU-C section in which it appears, and to include all defined terms in the glossary. Including the term *significant unusual transaction* in the definitions section of each section in which it appears would mean, for consistency, doing that for every term used in each section and the definitions sections would be very long, not to mention repetitive. Likewise, footnoting the first use of a defined term in every section would result in a very high number of footnotes.

See “Proposed Revisions to Proposed Amendments” section of this memo for additional conforming changes made for the use of the term “significant unusual transactions”.

## Issue 2: Proposed Amendment to AU-C section 240, paragraph 32

PCAOB Release No. 2014-002 includes conforming amendments to AS 2401 to require specified procedures for the auditor to evaluate fraud risks arising from significant unusual transactions. A proposed amendment to GAAS would amend paragraph .32 of AU-C section 240 as follows:

32. Even if specific risks of material misstatement due to fraud are not identified by the auditor, a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to ***accomplish the following***:

[No changes to list items *a–b*.]

c. Evaluate, ~~for significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual~~ given the auditor’s understanding of the entity and its environment and other information obtained during the audit, whether the business ~~rationale~~ ***purpose*** (or the lack thereof) of ***significant unusual transactions*** ~~the transactions~~ suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. ***The procedures should include the following***: (Ref: par. .A54)

- i. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction***
- ii. Determining whether the transaction has been authorized and approved in accordance with the entity’s established policies and procedures***

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<sup>1</sup> EY

<sup>2</sup> ALGA

- iii. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any*
- iv. Evaluating whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements*

Respondents were asked for their views on whether requiring these procedures, in particular the procedure of “evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any,” is appropriate for audits of financial statements of nonissuers or whether these procedures would be better placed as application material.

18 of the 22 respondents (82%) explicitly or implicitly agreed with proposed requirements i, ii, and iv. Three respondents<sup>3</sup> suggested they be moved to application material. One respondent<sup>4</sup> did not agree with keeping these as either requirements or application material.

Regarding proposed requirement iii, eight respondents<sup>5</sup> (36%) agreed with the proposed requirement, although 2 respondents suggested modifications to the requirement. 11 respondents<sup>6</sup> (51%) suggested moving the proposed requirement to application material, and seven respondents<sup>7</sup> (33%) suggested eliminating the item entirely. (Total of 120% is because four respondents (19%) were amenable to either eliminating the requirement or repositioning it as application material.)

The Task Force proposes to move 32(c)iii to application material with additional guidance on how to make the evaluation, which is consistent with application material in AU-C 550.

In addition, in response to comments<sup>8</sup> addressing concerns that entities may not have established policies and procedures over the authorization and approval of transactions, the Task Force proposes to amend 32c(ii) to be consistent with wording elsewhere in GAAS.

Proposed amendment, as revised (see also agenda item 5A, pages 20-21):

.32 ...

c. ...*The procedures should include the following:* (Ref: par. .A54)

- i. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with*

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<sup>3</sup> Crowe, GT, LL

<sup>4</sup> NC

<sup>5</sup> ALGA, CA, EY, FL, KPMG, NASBA, TIC, TN

<sup>6</sup> Anders, BDO, CB, Crowe, GT, IL, KPMG, LL, NSAA, PwC, WSA

<sup>7</sup> CA, MI, NC, KPMG, NSAA, PwC, WSA

<sup>8</sup> BDO, PwC

*explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction*

- ii. Determining whether the transaction has been appropriately authorized and approved*
- iii. ~~Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any~~*
- iv. Evaluating whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements*

*.A54A. Procedures for evaluating significant unusual transactions may include evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees and other obligations, if any. Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.*

#### **Question for ASB consideration**

1. Does the ASB agree with the proposed revisions to address Issue 2?

#### **Proposed Revisions to Proposed Amendments** (in order as shown in agenda item 5A)

##### *AU-C section 260*

Paragraphs 12f and A38: to better align with the requirement in paragraph 15 of AS 1301, *Communication with Audit Committees*, the proposed amendment to add application material to par. A38 was deleted, and the proposed amendment was elevated to a requirement in par. 12f.

##### Paragraphs 16A, 20, and A57

Two respondents<sup>9</sup> suggested that the amendment to par. A57 of AU-C 550, which was based on the note to par. 12 of AS 1301, be elevated to a requirement. Accordingly, the proposed amendment to par. A57 has been moved to par. 20.

One respondent<sup>10</sup> suggested that the note to par. 12 of AS 1301 be included as a requirement, to better align with AS 1301. Accordingly, the following amendment is proposed:

***16A. If, as part of its communication to those charged with governance, management communicated some or all of the matters the auditor is required to communicate, and as a***

<sup>9</sup> Crowe, KPMG

<sup>10</sup> KPMG

*result, the auditor did not communicate these matters at the same level of detail as management, the auditor should communicate any omitted or inadequately described matters to those charged with governance. The auditor does not need to communicate them at the same level of detail as management, as long as the auditor a) participated in management's discussion with those charged with governance, and b) affirmatively confirmed to those charged with governance that management has adequately communicated these matters.*

Paragraph .A36 – deleted. This amendment had been added as application material because it was considered too prescriptive as a requirement for non-issuers, but was thought to be useful guidance. However, two respondents<sup>11</sup> considered it not helpful, as they requested additional guidance to explain this guidance, and one respondent<sup>12</sup> thought it not necessary, because matters that may be communicated are always a matter of professional judgment.

#### **Question for ASB consideration**

2. Does the ASB agree with the proposed revisions to AU-C section 260?

#### ***AU-C section 550***

Multiple paragraphs (20, 26, A18, A42, A44, A45): References to “significant unusual related party transactions” have been revised to “significant related party transactions that are also significant unusual transactions” to clarify that they are both.

Paragraph 14: added “(including ownership structure)” to conform more consistently with PCAOB standard.

Paragraph 16: added “Unless all of those charged with governance are involved in managing the entity” and “(or the audit committee or, at least, its chair)” to be more consistent with PCAOB standard and wording used in AU-C section 240 paragraph .21

Paragraphs 17 through 23, and A22A and A35: in response to numerous comments, made the following changes:

- Reverted the heading before par. 17 to extant wording, to be consistent with wording of par. 17 that was not proposed to be revised.
- Moved proposed requirement from par. 23 to par. 17, because it is less in the nature of procedures and more in the nature of maintaining alertness. Moved related application material from par. A35 to new paragraph 22A.

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<sup>11</sup> BT, PwC

<sup>12</sup> NC

- Moved par. 18 to follow par. 23: par. 18 addresses procedures to be performed and is therefore more appropriately placed under the heading “Responses to the Risks of Material Misstatement Associated With Related Party Relationships and Transactions”.
- Changed “account balances” to “balances”

### Paragraphs 26 and A36

One respondent<sup>13</sup> noted that “the proposed changes to the requirement in paragraph 32 of AU-C section 240 are taken from paragraph 12 of AS 2410” and “that the incremental requirements would be better placed in AU-C section 550”. While the wording is the same, the proposed changes to paragraph 32 of AU-C section 240 were taken from conforming amendments to paragraph 66A of AS 2401 (see row 9 of agenda item 5D). Paragraph 12 of AS 2410 is comparable to paragraphs 18 and A36 of AU-C 550, specifically:

- Par. 12*a-c* of AS 2410 is comparable to par. 26*a-b*.
- Par. 12*d* of AS 2410 is comparable to application material added to par. A35. This is consistent with the revised amendment to AU-C 240, where this bullet is proposed to be moved to application material.
- Par. 12*e* of AS 2410, “perform other procedures as necessary to address the identified and assessed risks of material misstatement”, is a requirement elsewhere in GAAS (AU-C 330).

Par. 12 of AS 2410 applies to related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk. Par 24 (as amended, 26) of AU-C 550 applies to related party transactions that are significant unusual transactions.

The following changes are proposed to further align AU-C 550 with paragraph 12 of AS 2410:

**2426.** For ~~identified significant unusual~~ *each* related party transactions *that is either required to be disclosed in the financial statements or determined to be a significant risk* ~~outside the entity’s normal course of business~~, the auditor should

- a. ~~inspect~~ *read* the underlying contracts or agreements, if any, and evaluate whether
  - i. the business ~~rational~~ *purpose* (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.
  - ii. the terms of the transactions are consistent with management’s explanations.
  - iii. the transactions have been appropriately accounted for and disclosed.
- b. obtain audit evidence that the transactions have been appropriately authorized and approved.

A36. Examples of substantive audit procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions (whether due to fraud or error) include the following:

...

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<sup>13</sup> PwC

- With respect to material uncollected balances, guarantees, and other obligations, **obtaining evaluating** information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies.

Paragraph 29: Changed “findings and issues” to “findings or issues” for consistency

Paragraph A3, A42, A43, and A54: Change various wording to “economic substance” for consistency

Paragraph A11: Added “including the nature of the entity's relationships and transactions with those related parties” to be consistent with proposed changes to AU-C 600, paragraph .41.

Paragraph A16: added “whether such relationships or transactions were with known or previously unknown related parties” and “the human resources director or equivalent person” to more closely converge with PCAOB wording

Paragraph A53: revised proposed amendments into separate bullets to more closely align with PCAOB standard; changed second use of “findings and issues” to “findings or issues” as conforming change for consistency.

#### Changes not made to AU-C section 550 for ASB consideration

- 550.15, one respondent<sup>14</sup> believes this amendment would be better placed as part of the requirement in paragraph 14 to gain an overall understanding, rather than be specific to the auditor’s understanding of the controls management has established. It was originally proposed as application material to paragraph 14, and the ASB directed that it be a requirement applicable to the entity’s control process.
- 550.15, one respondent<sup>15</sup> recommended deleting “and arrangements” from this bullet in order to remain consistent with the newly defined term of significant unusual transactions. The term “significant transactions and arrangements” appears 7 times in AU-C section 550; two of those appearances are in the phrase “significant transactions and arrangements outside the normal course of business”.
- 550.16a, one respondent<sup>16</sup> requested an exception for governmental entities from asking those charged with governance to provide their understanding of the entity’s relationships and transactions with related parties that are significant to the entity. This comment was not included in comment letters received from other state auditors.<sup>17</sup>

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<sup>14</sup> PwC

<sup>15</sup> GT

<sup>16</sup> MI

<sup>17</sup> NSAA, WSA, ALGA

**Question for ASB consideration**

3. Does the ASB agree with the proposed revisions to AU-C section 550?

**Other sections:**

***AU-C section 240***

Paragraph 19: Changes proposed to soften the language to focus on internal audit's awareness or knowledge of any significant unusual transactions, from "whether the entity has ..." to "whether they are aware that the entity has...", and placed that phrase at the end for readability.

Paragraph 32a: added paragraph to change bullet (iii) for consistency

Paragraph 32c and A54A: See Issue 1.

Paragraph A19: Changes to clarify the meaning of "multiple elements".

Paragraph A54: Added "or any related party of the entity" to be consistent with PCOAB wording and alleviate any confusion, and changed "accounting principles applicable to that entity" to the "applicable financial reporting framework"; changed "economic reality" and "underlying economics", respectively, to "economic substance", for consistency.

***AU-C section 315***

Paragraphs A35, A139, A140, A144: Conforming changes for consistency

***AU-C section 330***

Paragraph A58: changed "substantive audit procedures" to "substantive procedures"

***AU-C section 560***

Paragraph A6: changed "the company" to "the entity" for consistency

***AU-C section 580***

Paragraph 17: moved the placement of the word "adequately" to be consistent with PCAOB amendment to par. 03 of AS 2805.

Paragraphs A15-A16: moved the placement of the amendment, because PCAOB amendment is not specific to those charged with governance.

Paragraph A18: Revised last bullet for clarity, to avoid double negative

***AU-C section 600***

Paragraph 41: changed "the company" to "the entity" for consistency

Paragraph A94: changed for consistency

***AU-C section 930***

Paragraph 21: moved the placement of the word “adequately” to be consistent with PCAOB amendment to par. 03 of AS 2805.

Paragraph A30: revised last bullet for clarity, to avoid double negative

*AU-C section 940*

Paragraphs A25 and A91: Changed for consistency

**Question for ASB consideration**

4. Does the ASB agree with the proposed revisions described above?