



NORTH CAROLINA
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STATE AND LOCAL GOVERNMENT FINANCE DIVISION
AND THE LOCAL GOVERNMENT COMMISSION

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To: Local Government Financial Officials and their Independent Auditors

From: Sharon Edmundson, Director, Fiscal Management Section

Subject: Clarified Auditing Standards

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The AICPA's Auditing Standards Board (ASB) has recently implemented new generally accepted auditing standards in an effort to make the standards easier to understand and apply and achieve more uniformity with the International Standards on Auditing (ISAs). These "Clarified Audit Standards" are now in effect. This memorandum will provide a brief overview of these standards, commonly referred to as the "Clarity Standards," will highlight some of the more common changes from the previous standards, and will discuss several areas in which the new Clarity Standards will impact audits of local government and public authorities in North Carolina.

The complete set of revised auditing standards is found in SAS No. 122, in *Statement of Auditing Standards: Clarification and Recodification*, except for SAS Nos. 117 to 120 which were issued in the new clarity format and are already in effect. SAS 122 supersedes all existing SASs through No. 116, and also No. 121. Other SASs not addressed in SAS No. 122 were either superseded by the subsequent SASs Nos. 124-126 or are currently being redrafted.

Each clarified standard uses the following format to make each easier to read and understand. Each standard also includes bulleted lists and may contain exhibits or appendices.

- Introduction - describes the standard in an overview manner.
- Objectives - provides the overall goal, purpose, framework, context, and application of the standard.
- Definitions - provides a glossary of terms contained within a certain standard.
- Requirements - contains the standard. They are presented as unconditional (indicated by must) or presumptively mandatory (indicated by should).
- Application or Other Explanatory Material - provides further guidance to the auditor in applying or understanding the requirements. It uses the term "may" when providing examples and other explanatory information. This section includes special considerations for audits of governmental entities.

Within the AICPA Professional Standards, the Clarity Standards and SAS Nos. 117-126, use "AU-C" section numbers instead of "AU" section numbers. "AU-C" is a temporary reference to avoid confusion of clarified and yet-to-be clarified standards and is to be used through 2013. The

Standards will revert back to “AU” from “AU-C” in 2014 when the AICPA has completed the clarity project.

Most of the Clarity Standards include guidance specifically for audits of governmental entities. Noted below are some of the more significant changes found in the 47 new “AU-C” sections:

Changes in the Independent Auditor’s Report: AU-C 700 – 799 *Audit Conclusions and Reporting* include the Clarity reporting standards. The most notable differences pertain to the appearance and presentation of the report, which now include paragraph headings. The headings precede sections such as management’s responsibility of the financial statements, auditor’s responsibility, and opinion. Specific language for each section is now required within the report.

The Clarity Standards require an explanation that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. 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 misstatements, whether due to error or fraud.

No longer are the reports referred to as “unqualified” or “qualified.” They are now referred to as “unmodified” or “modified.” Any items that were previously reported in an explanatory paragraph, such as litigation uncertainty, subsequent events, going concerns, etc., are now considered an “emphasis of matter” and should be included in the *emphasis of matter and other matter* paragraph following the opinion paragraph. Also included in this paragraph are the auditor’s responsibility in auditing required supplementary information and other supplementary information.

Sample reports that are unique to local governments and public authorities in North Carolina that have incorporated the Clarity Standards can be found at our website at www.nctreasurer.com. Under *Divisions*, select *Local Fiscal Management, Policies, Audit Manual* and 27A. Audit Opinions for Financial Reporting.

Modification to Engagement Letters: AU-C 210 *Terms of Engagement* requires the auditor to assess for recurring audits whether circumstances require the terms of the audit engagement to be revised. If the auditor concludes that the preceding terms need not be revised for the current engagement, the auditor should remind management of the terms of the engagement, either in writing or verbally, and the reminder should be documented. If the reminder is verbal, audit documentation may include with whom the discussion took place, when, and the significant points discussed.

AU-C 210 requires the auditor to determine whether the financial reporting framework, (the set of criteria used in the audit, such as Generally Accepted Auditing Principles, that is applied in the preparation of the financial statements) is acceptable in order to express an opinion on the financial statements. This has been implicit with current GAAP so this change will probably not affect current practice.

Audit of opening balances in an initial audit: AU-C 510 *Opening Balances – Initial Audit Engagements, Including Re-audit Engagements* requires that the auditor obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that

materially affect the current period's financial statements. The auditor also is required to determine if appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements or changes in policies are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor should perform such additional procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. The extent of additional procedures applied to an opening balance depends on the extent to which items in the opening balance also are in the closing balance and the audit approach for ending balances. **Reviewing a predecessor audit's report documentation cannot be the only procedure performed to obtain sufficient appropriate audit evidence regarding opening balances.**

Audit of Group Financial Statements: AU-C 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* provides audit guidance for circumstances where part of the work related to the financial statements is performed by auditor(s) that are either part of another firm, a network firm, or of the group audit engagement team's firm in a different location. AU-C 600 widens the scope of former guidance found in AU 543, *Part of the Audit Performed by Other Independent Auditors*. In addition, AU-C is consistent with ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditor)* except that AU-C 600 will allow reference of the work of another auditor in the auditor's opinion.

A key term used in AU-C 600 and the focus of the standard is "component." A component is defined as an entity or business activity for which a group or component management prepares financial information required by an applicable financial framework, such as GAAP. For governmental entities in North Carolina this standard will predominantly be applicable to the audit of component units as referenced in GASB Statement Nos. 14, 34, and 61. Component units as defined in GASB standards are not necessarily the same as components defined in the AICPA standard. Potential components are separate entities such as ABC Boards, Tourism Development Authorities, Water and Sewer Districts, etc., where it is not uncommon to have another auditor audit these entities. In addition, a potential component may be an activity such as auditing an account balance, observing the inventory count or inspection of capital assets. Also components as defined in AU-C 600 may apply to an equity interest in a joint venture. If an auditor of another branch of the same firm or with another firm audits these components, a decision needs to be made by the group engagement partner whether to make reference to the audit work of the component auditor in the group engagement auditor's report.

The responsibility of the auditor of the primary government of a governmental entity has expanded regardless of the auditor's decision to reference or not reference the other auditor's work in the primary government's audit report. If the auditor of the primary government historically only obtained and reviewed the component auditor's reports to support the audit opinion, the clarified standards will result in additional procedures related to the group audit process. When developing audit scope, pricing, and expectations, the group engagement partner may take in consideration the additional communication requirements and increased involvement with component auditors.

There are key terms used in AU-C 600 that clearly define the responsibilities of the group audit engagement partner and the component auditor. The group engagement partner will ultimately decide to either assume the responsibility for the work of a component auditor as it relates to the expression of an opinion on the group financial statements or not to assume responsibility and accordingly make reference to the component auditor in the auditor's report. Other key terms:

- Group audits - audits of group financial statements that include the financial information of more than one component unit. The objective is to issue a group audit opinion, an opinion on the group financial statements.
- Group - all components for which financial information is included in the group financial statements. A group always has more than one component.
- Component auditor – an auditor that is not part of the group engagement team, the group that establishes overall group audit strategy, who performs work on the financial information of a component that will be used as audit evidence for the group audit. As mentioned earlier, a component auditor could be with a branch of the firm or separate firm.
- Group engagement partner – the partner or other person in the firm who is responsible for the group audit engagement and its performance and for the auditor's report on the group financial statements that is issued on behalf of the firm.
- Significant component – a component identified by the group engagement team because 1) it is individually of financial significance to the group or 2) it is likely to include significant risks of material misstatement of the group financial statements because of its specific nature or circumstances.

We believe that governmental auditors in North Carolina will most likely decide to continue to reference component auditor(s) work in their reports. This will reduce the additional requirements found in AU-C 600 that would apply if the auditor assumed the responsibilities of the component auditor. Regardless, there are still additional procedures in AU-C 600 that will be required of the group auditor even if the component auditor is referenced. Some of these additional requirements are as follows:

- Acceptance and continuance: The group engagement partner should determine whether sufficient appropriate audit evidence can be obtained regarding the consolidation process and financial information by using the engagement team's work or using work of component auditors. This requires an understanding of the group, its components, and their environments sufficient to identify components that are likely to be significant components. This approach is a change from previous guidance that required the principal partner to consider coverage of the principal amounts and reliance on the other component auditors.
- The group engagement team's application of risk assessment: Most auditors have been taking into consideration the risk assessment standards and applying them to "components" but the new standards make it easier for the auditors to understand and apply the requirements. The clarified SAS references the clarified risk assessment standards and discusses their specific application in group audit situations.
- Understanding and working with the component auditor: There should be an assessment by the group engagement team on its ability to be involved with the work of the component

auditor. The group engagement team should determine whether it will be able to obtain information from the component auditor affecting the consolidation process.

- Determine whether a component auditor operates in a regulatory environment that actively provides oversight over auditors: These requirements are in addition to the requirements that were already in effect dictating that the group auditor gain an understanding of the component auditor's knowledge of ethical requirements, including independence and the component auditor's competence.
- Determination of materiality to be used to audit the components and the group financial statements: AU-C 600 requires the group engagement team to determine materiality and performance for the group as a whole, as well as component materiality. Component materiality is to be used to audit the financial information of a component for purposes of the group audit. If a separate auditor's report will be issued on the financial statements of a component, it can be expected that the materiality amount determined by the component auditor will be acceptable for the purpose of the group audit.
- Communications between the group engagement team and components auditors: AU-C 600 emphasizes two-way communication between the group auditor and the component auditors in order to achieve an effective and efficient group audit. The clarified SAS includes requirements that should be communicated by both parties. In addition specific items that are to be communicated to management and the governing board are included in the standard.
- Subsequent events: The group engagement team is now required to request the component auditor to notify them of any relevant subsequent events. Additional procedures are required to determine if subsequent events take place between the date of the auditor's report on the component and the date of the group auditor's report. Timing should be coordinated between the group auditor and the component auditor for subsequent event information.

Other significant changes from the previous standards: We believe that local government auditors in North Carolina should be aware of other changes of significance. This list is not all inclusive:

AU-C 200 Overall Objectives of the Independent Auditor and Conduct of an Audit in Accordance with Generally Accepted Auditing Standards: The clarified standards do not substantially change what was required of the auditor by the superseded AU General Standards, however the structure contained in the general, field work, and reporting standards has changed and new terminology is introduced. The Clarity Standards introduce the terms *financial reporting framework*, *applicable financial reporting framework*, *fair-presentation framework*, and *regulatory and contractual-based framework*.

AU-C 220 Quality Control for Engagement Conducted in Accordance with Generally Accepted Auditing Standards: This clarity standard now requires quality control procedures at the engagement level that assists auditors in achieving the objectives of quality control standards related to quality control systems, policies, and procedures concerning the audit firm. This should

not affect current practice since these are requirements established by Statement of Quality Control Standards No. 8 and should already be adhered to by the audit firm.

AU-C 250 *Consideration of Laws and Regulations in an Audit of a Financial Statement*: As part of the auditor's responsibility of trying to identify instances of noncompliance with other laws and regulations that may have a material effect on the financial statements, an additional requirement is that the auditor should inspect correspondences, if any, with the relevant licensing or regulatory authorities.

AU-265 *Communicating Internal Control Related Matters Identified in an Audit*: This Clarity Standard explicitly requires that the auditor is to communicate only to management, in writing or verbally, other deficiencies that, in the auditor's opinion, merit management's attention. Reporting these types of deficiencies was implicitly implied in practice and other deficiencies were commonly reported in "management letters" in previous years. Another change from previous guidance is that the auditor is now required to communicate, in writing, to management and those charged with governance an explanation of the potential effects of the significant deficiencies or material weaknesses, if any. These effects do not need to be quantified.

AU-C 501 *Audit Evidence – Specific Considerations for Selected Items*: This clarity takes a more principles based approach when an external attorney was consulted on any potential litigation. Auditors are required to send an attorney letter only if he or she believes actual or potential litigation claims or assessments may give rise to a risk of material misstatements. If the auditor does not send a letter, then he or she should document the reason for not doing so.

AU-C 550 *Related Parties*: This standard makes explicit the need to obtain an understanding of related-party relationships and transactions, including the related controls, during risk assessment, adds a specific requirement to discuss related parties during the engagement team discussion, requires treating significant related-party transactions outside the normal course of business as significant risks, and requires additional procedures for significant related-party transactions outside the normal course of business and if related parties not disclosed by management are identified.

AU-C 620 *Using the Work of an Auditor's Specialist*: The use of management specialists is now addressed in AU-C 501 *Audit Evidence* and should be evaluated by the auditor for relevance and reliability like any other audit evidence. A specialist may be a partner or staff, including temporary staff, of the auditor's firm or network firm as well as an external specialist.

More information, tools, and resources on the Clarity Auditing Standards and also on the AICPA's Clarity Project can be found at www.AICPA.org/SASClarity.

Should you have any questions concerning this memorandum, please contact Manasa Cooper at (919) 807-2390 or James Burke at (919) 807-2389 or via e-mail at manasa.cooper@nctreasurer.com or james.burke@nctreasurer.com.