



A Closer Look

Discussion and Analysis of Current Accounting and Audit Issues



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The Clarity Project — The AICPA Moves to Converge and Clarify Its Auditing Standards

During its meeting held from May 3–6, 2010, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) reviewed the status of its Clarity Project. At this meeting, the ASB voted to extend the proposed effective date of its finalized, but not yet issued, clarified standards. Those standards are now scheduled to be effective for audits of financial statements for periods ending on or after December 15, 2012. The extension, however, will not change the effective dates of the four clarified standards already issued by the ASB (see “Status of the Clarity Project” section below).

In this issue of “A Closer Look,” we examine the background, status, and implications of the Clarity Project and the new clarified standards of the ASB. In addition, we discuss how auditors should start planning for these changes.

Introduction

By now, most accountants have a working knowledge of the *FASB Accounting Standards Codification*™ (Codification). Although the Codification was not intended to change generally accepted accounting principles (GAAP) in the United States, it did affect the way accountants research and reference U.S.

GAAP. Because GAAP did not change, many CPAs believed that significant planning for the Codification was unnecessary. We believe that most practicing CPAs were surprised at the complexity of the Codification and have struggled with understanding and using it over the past year.

In all probability, few public accountants, specifically auditors, know a great deal about the ASB’s Clarity Project or its practical effect on their audit practices. Like the Codification, the goal of the Clarity Project is not necessarily to change authoritative standards, rather to make them easier to read, understand, and apply. We hope the recent and ongoing experience of transitioning to the Codification will help CPAs prepare for the adjustment to their practices that the Clarity Project will require.

Background of the Clarity Project

In 2004, the ASB undertook its two-pronged Clarity Project. First, the Clarity Project is intended to make existing U.S. auditing standards easier to understand and apply. Second, the Clarity Project is designed to converge U.S. generally accepted auditing standards (GAAS) with International Standards on Auditing (ISAs) issued by the International Auditing and

Assurance Standards Board (IAASB). The Clarity Project mirrors, to a large degree, an IAASB project that was completed in March 2009. In its convergence efforts, the ASB is using ISAs as the base for its clarified standards.

As with the Financial Accounting Standards Board (FASB) project that resulted in the

All AU sections are being evaluated and reissued in the clarified format.

Codification, the Clarity Project will result in a complete body of authoritative guidance for auditors of nonpublic companies. All AU sections of currently effective Statements on Auditing Standards (SASs) in AICPA *Professional Standards* are being evaluated and reissued in the clarified format (see the “Reorganization of Standards” section below).

Convergence

In accomplishing convergence with international standards, the ASB is also attempting to avoid conflict with Public Company Accounting Oversight Board (PCAOB) standards to the extent possible. However, the ASB has publicly recognized that some conflict between its newly clarified standards and those of both the IAASB and the PCAOB is unavoidable because of legal, regulatory, and other considerations.

For example, ISA 240 (Redrafted), *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, defines fraud as “... an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage [emphasis added].” The

proposed redrafted SAS, however, retains the concept of fraud in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, as an act “... that results in a material misstatement in financial statements that are the subject of an audit [emphasis added].”

The ASB believes that absolute convergence with international standards in this case “... could inappropriately expose auditors to additional liability in the [U.S.]” The ASB states in the exposure draft of the proposed SAS that the divergence between the definitions of fraud in the two standards will not create significant differences between the application of ISA 240 (Redrafted) and that of the redrafted SAS.

Reorganization of Standards

The ASB will issue many of the clarified standards in a single SAS that will be codified in AU section format. This process is the same as the one used when SAS No. 1, *Codification of Auditing Standards and Procedures*, was issued in 1972. SAS No. 1 contained all of the then existing standards codified in AU section format within the SAS. As a result of the Clarity Project, existing AU sections will be modified and guidance may be combined and moved into new sections. Once completed, the single clarified SAS will be issued using the next available number, such as “SAS No. 12X.”

In some cases, individual AU sections are being clarified “one for one” into individual clarified standards. In other cases, some AU sections are grouped together and clarified into one or more standards. As a result, topics currently associated with certain AU section numbers might be re-titled and assigned different AU section numbers in “SAS No. 12X.” The AICPA staff has published “Extant AU Sections Mapped to Clarity SASs,” which compares existing AU sections to their related ISAs. The document is available on *Accounting Research Manager*.

In addition, as the clarified standards are issued, the AICPA staff publishes supplementary materials. These materials include a comparison of the new clarified standards to international standards as well as information on the disposition of affected AU sections.

Status of the Clarity Project

The ASB has already issued as authoritative four clarified SASs. The ASB has also finalized, but not issued as authoritative, 11 clarified SASs. In addition, the ASB has developed a number of proposed or draft clarified SASs.

The four authoritative clarified SASs that have been issued address current practice matters. These standards would have been forthcoming whether or not the ASB was in the midst of its Clarity Project. However, because the Clarity Project was under way, the four standards were issued in a clarified format and are considered clarified standards. Those standards are effective as noted below.

The status of the clarified SASs, including the numbers and titles for the issued standards, is as follows:

- Issued (4):
 - SAS No. 117, *Compliance Audits*, is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Early application is permitted.
 - SAS No. 118, *Other Information in Documents Containing Audited Financial Statements*, is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.
 - SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole*, is effective for audits of financial statements for periods beginning on or

after December 15, 2010. Early application is permitted.

- SAS No. 120, *Required Supplementary Information*, is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.
- Finalized but not issued (11):
 - *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*;
 - Risk assessment standards, including redrafted standards (6); and
 - Other standards (4).
- Exposure drafts (30); and
- Other drafts (3).

In addition, the ASB has finalized but not yet issued its *Preface to Codification on Statements on Auditing Standards, Principles Underlying an*

Standard setting will continue to address current practice issues as the Clarity Project progresses.

Audit Conducted in Accordance With Generally Accepted Auditing Standards, which contains the principles underlying an audit conducted in accordance with GAAS.

The ASB expects to continue to issue standards that address current practice issues while the Clarity Project moves toward completion. Therefore, it is possible for additional standards to be released with earlier effective dates.

Finally, with the exposure process nearly complete, the ASB plans to review the clarified SASs for consistency. Further conforming changes to

clarified SASs may be required as other SASs are redrafted. However, any conforming changes are not expected to change the substance of the approved clarified SASs.

Fundamentals of Clarity Standards

As mentioned above, one of the primary objectives of the Clarity Project is to make auditing standards easier to understand. In addition, the project is designed to eliminate redundancies and clearly differentiate practical guidance from the requirements of the standards. To help accomplish these objectives, the ASB is employing certain conventions in drafting new and redrafting existing standards. These conventions call for the inclusion of the following sections:

- Statement of objective;
- Definitions, where relevant;
- Requirements; and
- Application and other explanatory material, with paragraphs using an “A” prefix.

The explanatory material in the “A” prefix paragraphs is cross-referenced to the corresponding paragraphs in the requirements section. The auditor is responsible for considering the entire text of each standard in applying its requirements.

The statement of objective is fundamental to the clarified standards.

The general, field work, and reporting standards — the 10 general standards — are being eliminated by the Clarity Project. However, the statement of an objective is fundamental to the clarified standards and, in a more principles-

based approach, serves to link the individual standards to the conceptual framework that formed the basis for those 10 standards. The general, field work, and reporting standards will still serve, to some degree, to provide structure to the auditing standards codification.

In addition, the drafting conventions call for the use of certain formatting techniques, such as bulleted lists, to enhance readability. Finally, special considerations that are relevant to the audits of both smaller, less complex entities and governmental entities are included where appropriate.

To review a clarified SAS that has been condensed to focus attention on the new formatting conventions, see attached *Appendix A—Example of Clarified Standards Drafting Conventions*.

Changes to Existing Standards

CPA firms that have structured their audit methodologies following the guidance issued by the IAASB and the best practices of the ASB should be better prepared when the clarified standards take effect. However, these firms will need to revise their existing guidance or work programs when referring to authoritative literature (see the “Planning for Implementation” section below).

As with the FASB Codification, the Clarity Project is not expected to significantly change existing audit guidance. However, based on the clarified standards that have been exposed for public comment, finalized, or issued by the ASB, specific examples of revisions to existing authoritative guidance include:

- Conceptual and practical use of the term “applicable financial reporting framework” rather than “generally accepted accounting principles”;
- Changes to wording of auditor’s reports, including the use of paragraph headings and

- expansion of the description of management's responsibilities;
- Explicit requirements for auditors related to the detection of illegal acts; and
- Additional requirements related to opening balances in initial audit engagements.

The concept of “financial reporting framework” is pervasive in the clarified standards.

As noted earlier in the “Reorganization of Standards” section, some existing AU sections will be merged and others will be split into different sections.

Professional Judgment

In the finalized (but not yet issued) SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, the ASB expands the guidance related to professional judgment. Paragraphs A26 through A30 of the SAS provide a discussion of the following: (a) specific decisions requiring professional judgment, (b) distinguishing features of professional judgment, and (c) the necessity that such judgment be supported by facts and circumstances.

Effective Date

The ASB's decision to delay the effective date of its clarified standards was driven by the following three factors:

1. Peer reviews indicate that many public accounting firms still find it difficult to

- properly apply the risk assessment standards issued in March 2006.
2. The FASB has projects pending that are likely to produce several new standards within the next year.
3. Small firms will likely need more time to assimilate and put into practice the new clarified standards.

Although the effective date of the clarified standards is now scheduled for audits of financial statements for periods ending on or after December 15, 2012, auditors are not precluded from considering the guidance in clarified standards as long as the auditor continues to comply with existing standards. The ASB maintains its belief that having a single effective date will ease the transition to, and the implementation of, its clarified standards.

The scheduled effective date for the clarified standards should allow CPA firms to close out their December 31, 2011, audits using the “old standards.” The firms could then begin preparing for their December 31, 2012, audits using the new standards.

Planning for Implementation

The ASB has indicated that its release of the finalized standards as they are approved and its delay of the effective date for its clarified standards serve to allow auditors more time for updating of and training in firm methodologies. Although substantive revisions to authoritative guidance are not substantial, auditors will need to modify their work programs — including both general and specific procedures — for changes in specific guidance as well as changes in references to authoritative standards.

Even though the standards will not be effective until 2012 calendar year audits, auditors should familiarize themselves with the redrafted standards

as they are finalized. CPA firms should begin the process of reviewing audit programs and refer-

Auditors should start to review clarified standards and existing firm guidance and audit programs.

ences to related AU sections. In addition, firms should consider providing their audit departments with ongoing training on the clarified standards.

Peer Reviews and Documentation

CPA firms generally have unique methodologies for performing confirmations, testing controls, and other audit procedures. Such methodologies should refer to the SASs issued by the ASB or the appropriate AU sections. To help avoid

unwelcome findings in peer reviews once the Clarity Project changes are effective, firms should ensure that any references to the authoritative literature match those in the redrafted clarified standards.

In addition, firms should carefully review each standard once finalized to ensure they have considered any nuances in the new literature that may require changes to audit procedures and training in accordance with the firms' quality control documents. Firms may also need to consider restructuring or revising their standard engagement letters.

Conclusion

The ASB's Clarity Project is moving rapidly toward its conclusion. Even though the effective date of most of the clarified standards has been postponed, CPAs should still monitor the new standards as they are finalized and prepare for any changes in their audit practices that the new standards will require. ■

Appendix A— Example of Clarified Standards Drafting Conventions

Statement on Auditing Standards, *Materiality in Planning and Performing an Audit*
[selected extracts of actual copyrighted SAS issued by the AICPA]

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Introduction

Scope of This Statement on Auditing Standards

1. This Statement on Auditing Standards (SAS) addresses the auditor’s responsibility to apply the concept of materiality in planning and performing an audit of financial statements. The clarified SAS *Evaluation of Misstatements Identified During the Audit* explains how materiality is applied in evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements.

Effective date included in Introduction

* * *

Effective Date

7. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2012.

Statement of Objective

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definitions section

Definition

9. For purposes of generally accepted auditing standards (GAAS), *performance materiality* means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, *performance materiality* also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement. (Ref: par. A2)

Requirements section

Requirements

Determining Materiality and Performance Materiality When Planning the Audit

10. When establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular classes of transactions, account balances, or disclosures exist for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users, then, taken on the basis of the financial statements, the auditor also should determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures. (Ref: par. A3–A13)

Cross-reference to Application and Other Explanatory Material

11. The auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures. (Ref: par. A14)

* * *

Documentation

14. The auditor should include in the audit documentation the following amounts and the factors considered in their determination:

- a. Materiality for the financial statements as a whole (see paragraph 10)
- b. If applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures (see paragraph 10)
- c. Performance materiality (see paragraph 11)
- d. Any revision of (a)–(c) as the audit progressed (see paragraphs 12–13)

Use of a list and a reference to related paragraph

Application and Other Explanatory Material

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: par. 5)

A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework and to report on the financial statements and communicate, as required by GAAS, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. *Audit risk* is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when

- a. determining the nature and extent of risk assessment procedures to be performed;
- b. identifying and assessing the risks of material misstatement;
- c. determining the nature, timing, and extent of further audit procedures; and
- d. evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

[Footnotes omitted.]

Performance Materiality (Ref: par. 9)

A2. *Tolerable misstatement* is the application of performance materiality to a particular sampling procedure. The proposed *SAS Audit Sampling* (Redrafted) defines and provides further application guidance about the concept of tolerable misstatement [footnote omitted].

Determining Materiality and Performance Materiality When Planning the Audit

Cross-reference to Requirements section

Considerations Specific to Governmental Entities (Ref: par. 10)

A3. In the case of a governmental entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) in an audit of the financial statements of a governmental entity, therefore, may be influenced by law or regulation.

A4. For most state or local governments, a governmental entity's applicable financial reporting framework is based on multiple reporting units, and generally, the auditor expresses or disclaims an opinion on a government's financial statements as a whole by providing opinions or disclaimers of opinion on each opinion unit. That is, a state or local governmental entity's applicable financial reporting framework requires the presentation of financial statements for its varied activities in various reporting units. Consequently, a reporting unit, or aggregation of reporting units, of the governmental entity represents an opinion unit to the auditor. Accordingly, in these cases, materiality is established for each opinion unit.

* * *

Special Considerations

Considerations Specific to Smaller, Less Complex Entities

A10. When an entity's profit before tax from continuing operations is consistently nominal, which might be the case for an owner-managed business in which the owner takes much of the profit before tax in the form of remuneration, a benchmark, such as profit before remuneration and tax, may be more relevant.

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