



Tax & Accounting

*CCH® ProSystem fx® Knowledge
Coach's Antidote to Common
Audit Documentation Deficiencies*

By George Georgiades, CPA, APC

“The skill of an accountant can always be ascertained by an inspection of his working papers.”

— Robert H. Montgomery,
Montgomery's Auditing, 1912

Audit documentation is not only important because it is required by professional standards, but also because it may serve as the auditor's first line of defense in litigation. Over the years, legal and disciplinary proceedings against auditors have identified multiple and repeated violations of audit documentation standards, including failure to prepare and maintain adequate and sufficient working papers. Similarly, peer reviews continue to identify common deficiencies related to audit documentation, including failures by auditors to appropriately document audit procedures, audit evidence, and conclusions reached with respect to management's assertions and the auditor's opinion on the financial statements.

Given the persistent and significant audit documentation deficiencies that auditors continue to face, it would seem imprudent for auditors to carry on as if their work will not be second guessed. That type of mindset or behavior is virtually impossible to counterbalance or defend when an independent third party (let alone an adversary) asserts the common notion that “work not documented is work not done.”

AICPA AU-C Section 230, *Audit Documentation*, addresses the auditor's responsibility in an audit of financial statements to prepare audit documentation that provides (1) an adequate record of the basis for the auditor's report and the achievement of the overall objectives of the auditor, and (2) evidence that the audit was planned and performed in accordance with generally accepted auditing standards (GAAS) and, if applicable, legal and regulatory requirements. AU-C Section 230 defines *audit documentation* as “The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as *working papers* or *workpapers* are also sometimes used).” Relevant audit evidence involves the quantity and quality of evidence which, ultimately, helps the auditor determine whether sufficient appropriate audit evidence is obtained.

AU-C Section 230 is the authoritative literature that provides guidance for documentation requirements for audits conducted in accordance with standards promulgated by the AICPA. However, other AICPA AU-C Sections also contain specific documentation requirements and guidance that are in addition to the requirements of AU-C Section 230. Accordingly, the auditor should address the specific documentation requirements of other AU-C Sections as well. In addition, to the extent that law, regulation, or other standards establish additional documentation requirements, the auditor should also comply with those requirements. [KBA-904](#) (*Audit Documentation Checklist*), a Knowledge-Based Audit resource offered by Wolters Kluwer, is an audit documentation checklist that is designed to help the auditor assess the completeness of the audit documentation. It summarizes the various audit documentation requirements under GAAS and outlines steps that are either required or recommended to finalize the audit file.

This white paper addresses common audit documentation deficiencies identified in peer reviews and recognized in valuable lessons from litigation, and is predominately based on the AICPA audit documentation requirements. Useful analogies can be easily made for audit documentation requirements established by other standard-setting bodies (e.g., the Public Company Accounting Oversight Board), laws or regulations. More importantly, this white

paper is intended to help auditors avoid these documentation deficiencies by identifying the primary practice aids in CCH ProSystem fx Knowledge Coach that address the various authoritative audit documentation requirements and by providing relevant practice points.

- Deficiency #1: Fraud
- Deficiency #2: Risk Assessment Procedures
- Deficiency #3: Audit Sampling
- Deficiency #4: Communication with Those Charged with Governance
- Deficiency #5: Audit Strategy and Audit Plan
- Deficiency #6: Analytical Procedures
- Deficiency #7: Materiality
- Deficiency #8: Accounting Estimates

CCH ProSystem fx Knowledge Coach is part of the Wolters Kluwer Integrated Audit Approach, and features a robust decision-support and coaching system for auditors and accountants built upon the Knowledge-Based Audit Methodology. The Knowledge-Based Audit Methodology is a risk-based methodology that emphasizes using knowledge of the entity

to make risk assessments in connection with a financial statement audit of that entity. This allows the auditor to more appropriately focus audit efforts on those areas which, in the auditor’s judgment, are the most significant and pose the most risk of material misstatement to the financial statements.

CCH ProSystem fx Knowledge Coach functionality allows auditors to use the Knowledge-Based Audit Methodology more efficiently by eliminating the need for duplicate entry of the same information, tailoring audit documentation to each particular engagement, and documenting the link between risks identified and procedures performed. There are over a dozen separate Knowledge-Based Audit industry titles, and each title features hundreds of programs, checklists, practice aids, example reports and example correspondence letters, as well as resource documents and links to further research material in the form of original pronouncements and interpretive guidance on CCH® Accounting Research Manager®.

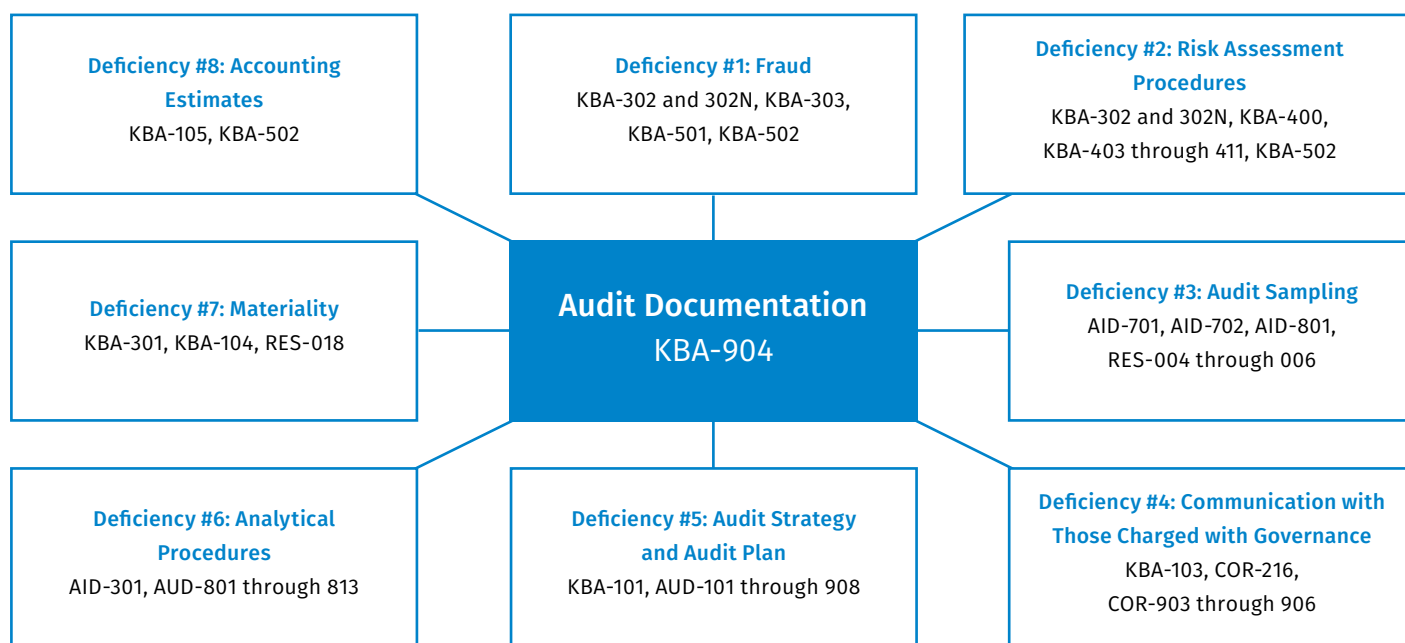


Exhibit 1. The Knowledge Coach Antidotes to Common Audit Documentation Deficiencies

This illustrates the common audit documentation deficiencies discussed below and the primary Knowledge Coach practice aids and programs that auditors can use to antidote their pitfalls.

DEFICIENCY #1: Failure to appropriately address fraud considerations, including lack of adequate documentation of procedures applied regarding risks of material misstatement due to fraud.

Key AU-C Section

Among other matters, AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit*, requires the audit documentation to include: (1) the significant decisions reached during the engagement team discussion about the susceptibility of the financial statements to material misstatement due to fraud; (2) the identified and assessed risks of material misstatement due to fraud at the financial statement and assertion levels; (3) the overall responses to the assessed risks of material misstatement due to fraud at the financial statement level; (4) the nature, timing and extent of audit procedures and the linkage of those audit procedures to the assessed risks of material misstatement due to fraud at the assertion level; (5) the results of the audit procedures, including those intended to address the risk of management override of controls; and (6) the reasons for the conclusion that the presumption of a risk of material misstatement due to fraud related to revenue recognition is overcome in the circumstances of the engagement, if the auditor has reached such a conclusion.

Knowledge Coach's Antidote

Key practice aids that help the auditor address this documentation deficiency related to fraud include:

- **KBA-302 and 302N** (*Understanding the Entity and Its Environment: Complex Entities & Noncomplex Entities*) are designed to document the auditor's evaluation of whether information obtained from risk assessment procedures indicates the presence of fraud risk factors.
- **KBA-303** (*Inquiries of Management and Others Within the Entity About the Risks of Fraud and Noncompliance With Laws and Regulations*) is designed to document the auditor's inquiries of management and others within the entity about the risks of fraud.
- **KBA-501** (*Team Discussion and Consideration of the Risks of Material Misstatement*) is designed to document the engagement team discussion of the susceptibility of the entity's financial statements to material misstatement due to fraud, including risks of material misstatement identified in the discussion, and the overall response to fraud risks.
- **KBA-502** (*Summary of Risk Assessments*) is designed to document the auditor's consideration of (1) whether identified fraud risks relate to specific assertions or to the financial statements as a whole; (2) the risk of management override of controls; and (3) the presumption that risks of fraud exist in revenue recognition. KBA-502 is also used to document the planned audit procedures and the linkage of those audit procedures to the assessed risks of material misstatement due to fraud at the assertion level.
- **RES-003** (*Consideration of Fraud in the Knowledge-Based Audit*) contains a list of KBA forms that address the auditor's responsibilities relating to fraud and how each KBA form addresses key requirements in AU-C Section 240.

Practice Point

The documentation of the exchange of ideas/brainstorming discussion among the engagement team members about the risks of fraud should include at a minimum:

1. the significant decisions reached during the engagement team discussion about the susceptibility of the financial statements to material misstatement due to fraud;
2. how and when the engagement team discussion took place; and
3. the audit team members who participated in the discussion.

DEFICIENCY #2: Lack of documentation around risk assessment procedures, including failure to properly and adequately document planning procedures relating to risk assessment and the linkage of risks to the procedures performed.

Key AU-C Sections

Among other matters, AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires documentation of (1) the auditor's understanding of the entity and its environment, including its internal control; (2) the risk assessment procedures performed to obtain such understanding; (3) the assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level and the basis for the assessment; and (4) the risks identified and related controls evaluated for significant risks that require special audit considerations and risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. In addition, AU-C Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, requires documentation of (1) the overall responses to address the assessed risks of material misstatement at the financial statement level; (2) the nature, timing, and extent of further audit procedures performed; (3) the linkage of those procedures to the assessed risks at the relevant assertion level; and (4) the results of the audit procedures performed and conclusions reached.

Knowledge Coach's Antidote

One of the fundamental building blocks in the Knowledge-Based Audit (KBA) methodology is its key design feature to clearly and directly link specific audit procedures to specified risks identified in connection with the auditor's risk assessment. Notably:

- **KBA-302 and 302N** (*Understanding the Entity and Its Environment: Complex Entities & Noncomplex Entities*) are designed to assist the auditor in identifying and documenting pertinent facts about the entity and its environment to be used in further risk assessment procedures, and to document potential risks of material misstatement.
- **KBA-400** (*Scoping and Mapping of Significant Account Balances, Classes of Transactions, and Disclosures*) is intended to help the auditor determine and document which audit areas have significant account balances, classes of transactions, and disclosures, or contain specific risks (i.e. significant risks, fraud risks and risks for which substantive procedures alone are not sufficient to reduce audit risk to an appropriately low level).
- **KBA-403 through KBA-411** (*Understanding Activity-Level Controls*) are designed to help the auditor perform and document the auditor's risk assessment procedures to gain an understanding of relevant activity-level controls for all significant account balances, classes of transactions, and disclosures, including documentation of the procedures performed, evidence obtained and conclusions reached.
- **KBA-502** (*Summary of Risk Assessments*) is designed to help the auditor summarize, assess and respond to risks of material misstatement identified in the audit, to document the basis for the risk assessments and to provide clear linkage between the assessed risk of material misstatement and the audit procedures performed.

Practice Point

When completing the KBA forms, it is important to recognize that the auditor is not required to consider, understand or document *all* controls that exist within an entity. Generally, controls that are relevant to an audit pertain to the entity's objective of preparing its financial statements that are fairly presented in conformity with the applicable financial reporting framework. Entities typically have additional controls that are not necessarily relevant to an audit and, therefore, need not be considered or documented. Examples include controls relating to the effectiveness, economy and efficiency of certain management decision-making processes, such as whether to make expenditures for certain research and development or advertising activities.

In addition, although internal control is relevant to the entire entity or to any of its operating units or business functions, an understanding or documentation of internal control relevant to each of the entity's operating units and business functions may not be necessary.

DEFICIENCY #3: Failure to adequately document audit sampling methodology.

Key AU-C Sections

AU-C Section 530, *Audit Sampling*, provides guidance regarding the performance of audit sampling in an audit engagement. Although AU-C Section 530 does not require specific documentation of audit sampling applications, the documentation requirements set forth in other standards (e.g., AU-C Section 230, *Audit Documentation*) apply to audit sampling applications just as they apply to other auditing procedures. Accordingly, if the sampling methodology is not documented, then the reviewer may not be able to evaluate whether the procedures performed provided sufficient appropriate audit evidence.

Knowledge Coach's Antidote

AID-701 (*Audit Sampling Worksheet for Tests of Controls*) and **AID-702** (*Results of Tests of Controls*) are designed to document audit sampling applications for tests of controls. **AID-801** (*Audit Sampling Worksheet for Substantive Tests of Details*) is designed to document audit sampling applications for substantive tests of details. RES-004 (*Audit Sampling Guidance for Tests of Controls*) and **RES-005** (*Audit Sampling Guidance for Substantive Tests of Details*) provide audit sampling guidance for tests of controls and substantive tests of details, respectively. RES-006 (*Sample Process Narrative*) is designed to aid the auditor in preparing process narratives for the various transaction processes management has implemented and in understanding how to identify key controls in the transaction process.



Practice Point

For tests of controls and substantive tests of details, audit documentation for audit sampling applications would include: (1) the definition of the population and the sampling unit, including how the auditor determined the completeness of the population; (2) what constitutes a deviation condition or misstatement; (3) the method of sample selection; (4) a description of the performance of the sampling procedures and a list of deviations or misstatements identified in the sample; and (5) the evaluation of the sample and a summary of the overall conclusion with respect to the population.

DEFICIENCY #4: Failure to communicate or document required communications with those charged with governance.

Key AU-C Sections

AU-C Section 260, *The Auditor's Communication With Those Charged With Governance*, addresses the auditor's responsibility to communicate with those charged with governance in connection with an audit of financial statements. Specifically, under AU-C Section 260, the auditor should: (1) document all matters that are required to be communicated with those charged with governance, when such matters have been communicated orally, including when and to whom such matters were communicated; and (2) retain as part of the audit documentation a copy of the communication when matters that are required to be communicated with those charged with governance have been communicated in writing.

AU-C Section 265, *Communicating Internal Control Related Matters Identified in an Audit*, requires the auditor to communicate to management: (1) in writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (2) in writing or orally, other deficiencies in internal control that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.



Knowledge Coach's Antidote

KBA-103 (*Evaluating and Communicating Internal Control Deficiencies*) can be used to document internal control deficiencies identified in the audit, including whether each deficiency is a material weakness, a significant deficiency or a deficiency in internal control.

COR-216 (*Communication with Those Charged with Governance During Planning*) and **COR-903 through COR-906** (*Letters Communicating Internal Control Deficiencies*) can be used to communicate or document required communications with those charged with governance and management.

Practice Point

Documentation of oral communication may include a copy of minutes prepared by the entity as part of the audit documentation if those minutes are an appropriate record of the communication.

DEFICIENCY #5: Failure to document the overall audit strategy, the audit plan, or any significant changes made thereto during the audit engagement.

Key AU-C Section

AU-C Section 300, *Planning an Audit*, requires the auditor to include in the audit documentation: (1) the overall audit strategy; (2) the audit plan; and (3) any significant changes the auditor made to the overall audit strategy or audit plan during the course of the engagement, and the reasons for those changes.

Knowledge Coach's Antidote

KBA-101 (*Overall Audit Strategy*) is designed to help the auditor (1) document the initial overall audit strategy; (2) capture the initial information (e.g., risk assessment procedures) that will be useful in the development of a more detailed audit plan; and (3) document changes to the overall audit strategy as changes in circumstances arise throughout the audit.

AUD-101 (*Overall Audit Program*) is designed to help guide the auditor through the development of the audit plan. This overall audit program is supplemented by other forms and practice aids, including audit programs **AUD-201 through AUD-908** (*Audit Programs*) to help the auditor perform various audit procedures. *Audit Program* documents typically contain steps and procedures that are required by auditing standards in many areas of the audit and are designed to guide the auditor through the execution of related steps and procedures. The auditor develops and documents the "audit plan," including any changes thereto, as he or she customizes these documents.

Practice Point

The documentation of the overall audit strategy includes the key decisions considered necessary to plan the audit and communicate significant issues to the audit team (e.g., a memorandum summarizing key decisions about the scope, timing and conduct of the audit may be sufficient).

The documentation of the audit plan includes the planned nature, timing and extent of risk assessment procedures and further audit procedures at the relevant assertion level. Standardized audit programs and checklists may be used, provided they are tailored to the circumstances of the engagement. This includes tailoring them to the risk assessment for the engagement.

The documentation of any significant changes to the overall audit strategy or audit plan, and the reasons for those changes, includes changes to the planned nature, timing and extent of audit procedures and why the overall strategy and audit plan were finally adopted for the audit.

AU-C Section 300, *Planning an Audit*, acknowledges the widespread use of what it calls "standard audit programs or audit completion checklists." However, it reminds auditors of the need to tailor such programs and checklists to each particular audit.

DEFICIENCY #6: Lack of documentation of expectations for analytical procedures and related actions when substantive analytical procedures have been performed.

Key AU-C Section

AU-C Section 520, Analytical Procedures, requires the auditor to document the following matters when substantive analytical procedures have been performed:

- The expectation of recorded amounts or ratios that the auditor developed, including whether the expectation is sufficiently precise to identify a misstatement that may cause the financial statements to be materially misstated.
- The factors the auditor considered in developing the foregoing expectation when that expectation or those factors are not otherwise readily determinable from the audit documentation.
- Results of the comparison of the recorded amounts, or ratios developed from recorded amounts, with the expectations.
- Any additional auditing procedures the auditor performed relating to the investigation of fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, and the results of such additional procedures.

Knowledge Coach's Antidote

AID-301 (*Preliminary Analytical Procedures: Fluctuation and Ratio Analysis*) and **AUD-801 through AUD-813** (*Audit Programs*) have been designed to help the auditor perform and document analytical procedures, including the development of expectations, the comparison of the expectations to actual or recorded amounts and the investigation of significant variances from the auditor's expectations.

Practice Point

When documenting the results of the comparison of the recorded amounts, or ratios developed from recorded amounts, with the auditor's expectations, it is essential for the auditor to decide whether a fluctuation in an analytical procedure is material. When planning analytical procedures, the auditor typically sets the materiality thresholds for accepted deviations from expected amounts and results. Professional literature does not provide much guidance in this area. However, it is observed that in practice, auditors use one or both of the following approaches:

- *Deviation exceeds a preestablished dollar amount threshold.* For example, the auditor may decide that a \$10,000 misstatement is unacceptable in the audit of payroll taxes expense. If a difference exceeding that amount is uncovered, the auditor would perform additional detail testing; otherwise, payroll taxes expense would not be considered fairly stated.
- *Deviation exceeds a preestablished percentage threshold.* Under this approach, the auditor compares, for example, the current year's general and administrative expense accounts with the prior year's and computes the percentage change. If the percentage change exceeds what the auditor believes is appropriate (e.g., 10%), the deviation would be considered material and would require further investigation. This approach, however, could result in more work than necessary if there are many small dollar account balances.

DEFICIENCY #7: Lack of documentation of materiality considerations including those relating to uncorrected misstatements.

Key AU-C Sections

AU-C Section 320, *Materiality in Planning and Performing an Audit*, requires documentation of the following amounts and the factors considered in their determination: (1) materiality for the financial statements as a whole; (2) materiality level(s) for particular classes of transactions, account balances or disclosures, if applicable; (3) performance materiality; and (4) any revisions of the preceding three items during the progress of the audit.

AU-C Section 450, *Evaluation of Misstatements Identified During the Audit*, requires the auditor to document: (1) the amount below which misstatements are considered to be clearly trivial; (2) all misstatements accumulated during the audit (other than those considered to be clearly trivial) and whether they have been corrected; and (3) a conclusion as to whether uncorrected misstatements are material, either individually or in the aggregate, and the basis for that conclusion.

Knowledge Coach's Antidote

KBA-301 (*Worksheet for Determination of Materiality, Performance Materiality, and Thresholds for Trivial Amounts*) is designed to help the auditor determine and document materiality for the financial statements as a whole, performance materiality and the thresholds for trivial amounts. **KBA-104** (*Summary and Evaluation of Misstatements and Omitted, Inaccurate, or Incomplete Disclosures*) is designed to help the auditor summarize and evaluate all identified misstatements, including uncorrected misstatements and those corrected by management.

RES-018 (*Determination of Materiality, Performance Materiality and Thresholds for Trivial Amounts*), which can be used in conjunction with **KBA-301**, provides additional guidance to the auditor for the determination of an appropriate benchmark, materiality, performance materiality and the threshold for "trivial" amounts.

Practice Point

The documentation requirements under AU-C Section 320, *Materiality in Planning and Performing an Audit*, in regard to materiality levels include the phrase "and the factors considered in their determination" in an inconspicuous fashion. They are nonetheless an important requirement, and one that practitioners may easily miss. The intent of this requirement seems to indicate that materiality, and its various levels, should not be solely numbers derived from the mechanical application of formulas contained in practice aids, or numbers chosen randomly with no apparent rationale.

The practical implication of this requirement is that when auditors are choosing a benchmark for determining materiality for the financial statements as a whole, for example, they need to state why that benchmark is applicable or more appropriate than another likely benchmark. The choice of a benchmark is in itself a matter of professional judgment, and the standards place no limits on the auditor in the process as long as the rationale is documented. For example, pre-tax profit before owners' remuneration may be appropriate for small, privately-held entities, as owners typically take out most of the profits and leave only the nominal net income. Similarly, entities such as non-profit organizations or some types of governmental units do not operate for the purpose of generating a profit, thus using a profit-based benchmark is usually inappropriate.

DEFICIENCY #8: Lack of documentation of the basis for the auditor's conclusions about the reasonableness of accounting estimates that give rise to significant risks, including indicators of possible management bias.

Key AU-C Sections

AU-C Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, requires the auditor to specifically document: (1) the basis for the auditor's conclusions about the reasonableness of those accounting estimates, including related disclosures, that give rise to significant risks, and (b) indicators of possible management bias, if any.

Knowledge Coach's Antidote

KBA-105 (*Review of Significant Accounting Estimates*) is designed to help the auditor document and evaluate management's significant accounting estimates. It provides a table that can be used in evaluating management's estimates for evidence of bias. The table compares the recorded amount of an estimate to the range of amounts supported by the audit evidence for the current and prior periods. This table can also be used to perform and document the required retrospective review of significant accounting estimates.

KBA-502 (*Summary of Risk Assessments*) can be used to document the basis for the auditor's conclusions about the reasonableness of those accounting estimates that give rise to significant risks.

Practice Point

Documentation of indicators of possible management bias assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate and in evaluating whether the financial statements are free from material misstatement. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, based on management's subjective assessment that there has been a change in circumstances.
- An entity's use of its own assumptions for fair value accounting estimates when they are inconsistent with observable market assumptions.
- Management's selection or construction of significant assumptions that yield a favorable point estimate for its objectives.
- Management's selection of a point estimate that may indicate a pattern of optimism or pessimism.

For more information about CCH ProSystem fx Knowledge Coach, Wolters Kluwer's Integrated Audit Approach or Knowledge-Based Audit resources, contact a solutions consultant at 800-739-9998, or visit [CCHGroup.com/QualityAudit](https://www.cchgroup.com/QualityAudit) today!

Contact information:

Wolters Kluwer
2700 Lake Cook Road
Riverwoods, IL 60015
United States
800-739-9998

Please visit CCHGroup.com/QualityAudit
for more information.

