



Audit Risk Alert

2017/18 | General Accounting and
Auditing Developments

Strengthening Audit Integrity
Safeguarding Financial Reporting

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**Strengthening Audit Integrity
Safeguarding Financial Reporting**

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Notice to Readers

This Audit Risk Alert (alert) replaces *General Accounting and Auditing Developments—2016/17*.

This alert provides auditors of financial statements with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. Also, an entity's internal management can use this alert to address areas of audit concern.

This publication is an other auditing publication, as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards.

In applying the auditing guidance included in an other auditing publication, the auditor should, using professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully acknowledges those members of the Auditing Standards Board and the AICPA Technical Issues Committee who helped identify the interest areas for inclusion in this alert. The AICPA also gratefully acknowledges Jeremy Dillard, David Finkelstein, and Patrick Ballweg for their review of this publication.

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Feedback

The Audit Risk Alert *General Accounting and Auditing Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's alert, please feel free to share them with us. Any other comments you have about the alert would also be appreciated. You may email these comments to A&APublications@aicpa.org.

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How This Alert Helps You

.01 This alert helps you plan and perform your audits and can be used by an entity's internal management to identify issues significant to the industry. It also provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the risks that may result in the material misstatement of financial statements, including significant risks requiring special audit consideration. For developing issues that may have a significant impact in the near future, the "On the Horizon" section provides information on these topics. Refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. Auditors obtain audit evidence to draw reasonable conclusions on which to base their opinion by performing the following:

- Risk assessment procedures
- Further audit procedures that comprise the following:
 - Tests of controls, when required by generally accepted auditing standards (GAAS) or when the auditor has chosen to do so
 - Substantive procedures that include tests of details and substantive analytical procedures

.03 The auditor should develop an audit plan that includes the nature and extent of planned risk assessment procedures, as determined under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.¹ AU-C section 315 defines *risk assessment procedures* as "the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels." A *relevant assertion* "has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of internal controls." As part of obtaining the required understanding of the entity and its environment, paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of the "industry, regulatory, and other external factors, including the applicable financial reporting framework," relevant to the entity. This alert assists the auditor with this aspect of the risk assessment procedures and further expands the auditor's understanding of other important considerations relevant to the audit.

Economic and Industry Developments

The Current Economy

.04 When planning an audit or review engagement, auditors need to understand the economic conditions facing the industry and marketplace in which

¹ All AU-C sections can be found in AICPA *Professional Standards*.

an entity operates, as well as the effects of these conditions on the entity itself. These external factors, such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions, are likely to have an effect on an entity's business and, therefore, its financial statements. Considering the effects of external forces on an entity is part of obtaining an understanding of the entity and its environment. Recognizing that economic conditions and other external factors relevant to an entity and its environment constantly change, auditors should evaluate whether changes have occurred since the previous audit that may affect their reliance on any information obtained from their previous experience with the entity. These changes may affect the risks and risk assessment procedures applicable to the current year's engagement.

.05 During 2016 and into 2017, the U.S. economy continued to recover. The S&P 500 and the Dow Jones Industrial Average both reached all-time highs during 2017. The Chicago Board Options Exchange Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock option prices and is considered by many to be a reliable indicator of investor sentiment and market volatility and the best gauge of fear in the market. The VIX continued to show an overall decline during 2016 and into 2017. During that time, prices ranged from 14.40 to 9.36. The volatility shows that there is still some uncertainty; however, the continued downward trend shows that investors believe the economy and market are improving.

Key Economic Indicators

.06 The following key economic indicators reaffirm the recovery of the economy during 2016 and into 2017: gross domestic product (GDP), unemployment, and the federal fund rate. The GDP measures output of goods and services by labor and property within the United States. GDP increases as the economy grows and decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.6 percent in the second quarter of 2017, based on the advance estimate (first estimate). The increase in real GDP in the second quarter has been attributed to positive contributions from personal consumption expenditures, nonresidential fixed investment, exports, and federal government spending that were partially offset by negative contributions from private residential fixed investments, private inventory investment, and state and local government spending.

.07 According to the Bureau of Labor Statistics (BLS) from July 2016 to July 2017, the unemployment rate fluctuated between 4.9 percent and 4.3 percent. A rate of 4.9 percent represents approximately 87.4 million people who are unemployed. During that same time period, the number of long-term unemployed (those jobless for 27 weeks or more) was steady. According to the BLS, the number of people employed part-time for economic reasons decreased to 5.3 million during the second quarter of 2017. Together, these statistics illustrate the continued improvement in the economy.

.08 The Board of Governors of the Federal Reserve System (Federal Reserve) increased the target for the federal funds rate in June of 2017 to 1.0 percent. This was the second raise of the rate during 2017 after keeping the rate at 0.5 percent for over a year.