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New 'higher' risk designation for audits and requirements for audit teams and the engagement quality reviewer on these audits

Overview

To help better identify and manage risk, we have created a "higher" risk designation in the engagement acceptance and continuance process. Higher risk audits are those that have risk factors that are higher than what we now define as moderate but do not warrant a close monitoring designation. An audit will be preliminarily designated as higher if the team selects specific risk factors in the process for acceptance of clients and engagements (PACE) or selects several factors that create an accumulated risk that triggers the designation. For example, an audit with a tax risk rating of 4 is presumed to be higher risk. As always, partners in charge of audits will be able to change the final risk designation with approval from the Professional Practice Director assigned to the Region and the Region Assurance Managing Partner.

A higher risk designation will affect the requirements for (1) documenting our evaluation of the composition of the team, (2) designing and documenting the nature, timing and extent of our audit procedures, including our supervision and review procedures, (3) performing the engagement quality review, (4) determining tolerable error and (5) executing certain risk management procedures.

These requirements are effective immediately for financial statement audits for all clients recently accepted and for those subject to the 2018 continuance process (generally audits with fiscal periods ending after August 2018, including those currently in progress). EY GAM, the US Assurance Policy Manual (US APM), related existing audit releases and policy statements and applicable forms and templates will be updated to reflect these requirements. Teams should refer to US APM 1.9.7 which has been updated to reflect new advance approval requirements relating to the higher risk designation.

Requirements for higher risk audits

Form 125US Acceptance and continuance risk factor response form

For our audits designated as higher risk, we are required to use Form 125US *Acceptance and continuance risk factor response form* to document the following:

- The evaluation of the composition of the team by the partner in charge of the audit (PIC) and the engagement quality reviewer, and for income tax considerations, the tax account leader
- Our planned response, including our planned work assignments and supervision and review plan, to the risk factors identified during engagement acceptance or continuance that led to or contributed to the higher risk designation or that are associated with a fraud or other significant risk
- The results of procedures performed as of the post-interim event, including the identification of any new risk factors considered significant, any changes to our audit plan we have made in response to those risk factors and any changes to the planned work assignments and supervision and review plan
- Our evaluation of the results of our audit procedures and our overall conclusion about whether we have appropriately responded to the risk factors identified in PACE and any fraud or other significant risks identified outside of that process
- When applicable, our interim review actions or procedures, including the planned interim review work assignments and supervision and review plan, to address the risk factors that led to or contributed to the higher risk designation or that are associated with a fraud or other significant risk

Determining appropriate work assignments, supervision and review

An audit manager, senior manager, executive director or partner is required to review the workpapers in areas affected by the risk factor(s) that led to or contributed to the higher risk designation.

Rotating tests of controls

A rotational controls reliance strategy is prohibited on a non-issuer audit designated as higher risk for significant classes of transactions that are affected by the risk factors that gave rise or contributed to the higher risk designation. A rotational controls reliance strategy is prohibited for audits of all public companies, regardless of risk designation.

Engagement quality review (EQR)

An EQR is required for non-issuer audits designated as higher risk that are conducted in accordance with the auditing standards of the American Institute of Certified Public Accountants. We document our EQR for these entities using Form 305US *Engagement quality reviewer program for non-issuer audits,* which has been tailored for non-issuers.

Determination of tolerable error (TE)

We give careful consideration to the reasons for our higher risk designation and whether it relates to factors or conditions that could pose a pervasive or specific risk of material misstatement in the financial statements. In these situations, we use professional judgment to determine whether to set TE at 50% of planning materiality (PM) because we recognize that the risk of undetected misstatements increases. Our considerations of the risk factors identified and our conclusions about TE must be documented in the workpapers.

For example, when an uncorrected misstatement was identified in the prior year that required consultation with the Professional Practice Director assigned to the Region, we may conclude that a specific risk of material misstatement exists for the related significant account in the current year. When determining TE, we may conclude that 75% of PM is reasonable. However, in response to the specific risk identified, we need to plan to alter the nature, timing and extent of our procedures related to that significant account. If the prior-year consultation related to multiple audit misstatements identified, we may conclude that the risk is more pervasive and that setting TE at 50% of PM is appropriate.

Change in risk designation as of an interim date

The PIC should reevaluate the risk designation of the entity throughout the year. If additional risk factors are identified as of an interim date, the PIC should reevaluate the risk designation with the Region QIL, CAML, TARAS Leader (for income tax considerations) or Professional Practice Director assigned to the Region to determine whether a higher risk designation is appropriate. **We are required to obtain advance approval from the Regional Assurance Managing Partner and the Professional Practice Director assigned to the Region prior to determining the appropriate actions to take when the partner in charge of the audit determines, while the audit is in process, that the entity should be designated as higher risk.**

If certain risk factors no longer exist as of an interim date, the PIC should reevaluate the higher risk designation with the Region QIL, CAML, TARAS Leader (for income tax considerations) or Professional Practice Director assigned to the Region. **We are also required to obtain advance approval from the Regional Assurance Managing Partner and the Professional Practice Director assigned to the Region to remove a higher risk designation**.

These matters require advance approval from the Professional Practice Director assigned to the Region and should not be delegated to other partners within the PPD group. We summarize the rationale for the change in risk designation in a memorandum to be retained in our workpapers.