

Select Auditing Considerations for the 2016 Audit Cycle

We are pleased to release our *Select Auditing Considerations for the 2016 Audit Cycle* (the 2016 CAQ Alert), which is our fourth annual alert of this type and represents a part of the profession's commitment to continuously strengthening audit quality. The 2016 CAQ Alert can be a useful resource for our member firms and is intended to serve as a reminder of certain auditing considerations that may be relevant for the 2016 audit cycle. The 2016 CAQ Alert discusses some of the more judgmental or complex audit areas, including some of those identified by the Public Company Accounting Oversight Board (PCAOB or Board) through its inspection process and published in the recent PCAOB Staff Inspection Briefs. While the 2016 CAQ Alert highlights certain areas for consideration, it should not be relied upon as definitive

or all-inclusive, and should be read and considered in conjunction with the applicable rules, standards, and guidance in their entirety. In addition to the 2016 CAQ Alert, the CAQ has also issued an alert, [Select Considerations for the 2016 Audit Cycle for Brokers and Dealers](#). It addresses some of the more judgmental or complex audit areas related to audits of brokers and dealers and provides select information related to these areas.

The executive summary provides a high level synopsis of the key topical areas the 2016 CAQ Alert will cover. Following the summary, starting on page 4, is more context around each topic, as well as useful resources our member firms may reference as they prepare for the 2016 audit cycle.

Executive Summary

[Improving Transparency through Disclosure of Engagement Partner and Certain Other Participants in Audits: PCAOB Rules 3210 and 3211](#)

In May of 2016, the SEC approved [Rule 3210, Amendments](#) and [Rule 3211, Auditor Reporting of Certain Audit Participants](#), (the new rules). The Board chose a phased effective date.¹ For all issuer audit reports of a registered public accounting firm issued:

- ▶ on or after January 31, 2017 the engagement partner name is reported on a new form (Form AP); and
- ▶ on or after June 30, 2017 information about other accounting firm(s)² participation in the audit is reported on Form AP.

¹ See PCAOB [Release No. 2015-008](#) Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards, VII Effective Date.

² General Instruction 2 of Form AP defines "the Firm" as "the registered public accounting firm that is filing this Form with the Board;" and "other accounting firm" as "(i) a registered public accounting firm other than the Firm; or (ii) any other person or entity that opines on the compliance of any entity's financial statements with an applicable financial reporting framework."

Form AP is due by:

- ▶ the 35th day after the date the audit report is first included in a document filed with the U.S. Securities and Exchange Commission (SEC); or
- ▶ the 10th day after the date the audit report is first included in a Securities Act registration statement filed with the SEC.

Improper Alteration of Audit Documentation

In April of 2016, the PCAOB issued [Staff Audit Practice Alert No. 14](#), *Improper Alteration of Audit Documentation* (Practice Alert No. 14) addressing improper alteration of audit documentation in connection with a PCAOB inspection or investigation. Practice Alert No. 14 highlights that the PCAOB's rules require the auditor to cooperate with the Board's oversight activities and that failure to do so (including providing improperly altered documents or misleading information to the PCAOB's staff) can result in disciplinary actions with severe consequences.

Effective Communication with Audit Committees

In April of 2016, the PCAOB issued [Release No. 2016-001](#), *Inspection Observations Related to PCAOB Rules and Auditing Standards on Communications with Audit Committees* (PCAOB Release No. 2016-001). PCAOB Release No. 2016-001 highlights requirements related to audit committee communications and provides examples of inspection findings from the PCAOB's 2014 and preliminary 2015 inspection results.

Assessing and Responding to Risks of Material Misstatement

In October of 2015, the PCAOB issued [Release No. 2015-007](#), *Inspection Observations Related to PCAOB "Risk Assessment" Auditing Standards (No. 8 through No. 15)* (PCAOB Release No. 2015-007). The Risk Assessment Auditing Standards³ establish requirements that "enhance the effectiveness of auditors' assessment of and response to risk through: (1) performing procedures that provide a reasonable basis for identifying and assessing risks of material misstatement, whether due to error or fraud, (2) tailoring the audit to respond appropriately to the risks of material misstatement, and (3) making a comprehensive evaluation of the evidence obtained during the audit to form the opinion(s) in the auditor's report."⁴ The PCAOB staff indicated, in connection with its preliminary observations from 2015 inspections, that "assessing and responding to risks of material misstatement are two critical components of an audit. Improper application of these standards may result in audit deficiencies that contribute to an unsupported audit opinion or, in some cases, unnecessary or excessive audit work."⁵

Internal Control over Financial Reporting (ICFR)

Auditors should continue to focus on performing procedures to identify, test and evaluate controls that address the assessed risk of material misstatement, and in particular those controls that contain a review element.⁶ In recent speeches,⁷ SEC staff reminded issuers and their auditors of the need to begin focusing on internal control-related implications of the implementation of new accounting standards, including those that relate to disclosures of the implementation status during the transition period, where applicable. The new accounting standards highlighted include:

- ▶ Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) [No. 2014-09](#), *Revenue from Contracts with Customers* (ASU No. 2014-09) effective for calendar year-end public companies in 2018;
- ▶ FASB ASU [No. 2016-02](#), *Leases (Topic 842)* effective for calendar year-end public companies in 2019; and
- ▶ FASB ASU [No. 2016-13](#) *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses in Financial Instruments* effective for calendar year-end public companies in 2020.

3 These standards include AS 1101, AS 2101, AS 1201, AS 2105, AS 2110, AS 2301, AS 2810, AS 1105 (currently AS 8 – AS 15).

4 See page 5 of PCAOB Release No. 2015-007.

5 See pages 5-6 of PCAOB [Staff Inspection Brief 2016-01](#) for examples of deficiencies identified in this area.

6 See related discussion on page 3 of PCAOB [Staff Inspection Brief 2016-03](#).

7 For example, see [remarks](#) made by Wesley R. Bricker, SEC Interim Chief Accountant, at the AICPA National Conference on Banks & Savings Institutions.

Furthermore, testing of internal controls over income tax accounting and disclosures, another complex area, continues to warrant auditor attention.

Segment Identification and Disclosure

Recently SEC staff has focused on segment reporting. Tests of controls related to management's determination of operating and reportable segments—as well as controls over monitoring of events giving rise to changes in segment determination and disclosure controls—were also identified as potential focus areas for 2016 PCAOB inspections.⁸

Going Concern

The FASB [ASU No. 2014-15](#), *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* (ASU No. 2014-15) becomes effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. The ASU establishes new requirements for management to assess a company's ability to continue as a going concern when preparing financial statements and necessary disclosures. In light of the ASU issuance, the PCAOB indicated in the [Staff Audit Practice Alert No. 13](#), *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern* (Practice Alert No. 13), that the auditor should continue to apply the requirements of [Auditing Standard \(AS\) 2415](#) (currently AU sec. 341), *Consideration of an Entity's Ability to Continue as a Going Concern* (AS 2415). AS 2415 provides qualitative factors for auditors to consider in evaluating whether substantial doubt exists. A determination that no disclosure is required under the ASU provisions is not conclusive as to whether an explanatory paragraph is required in the auditor's report. Auditors should make a separate evaluation of the need for disclosure in the auditor's report in accordance with the requirements of AS 2415.

Additional Considerations for the 2016 Audit Cycle

Auditors should continue to focus on appropriately applying recently adopted PCAOB rules and auditing standards and certain other areas highlighted in the 2016 and prior CAQ Alerts. Certain economic developments⁹ and increased use of technology, among other factors, may potentially impact select areas of the audit, including, but not limited to:

- ▶ auditing accounting estimates, including fair value measurements;
- ▶ assessment of whether cybersecurity risks present risks of material misstatement to the issuer's financial statements;
- ▶ auditor independence, including the impact of consulting, advisory and other services;
- ▶ the firms' compliance with [AS 2410](#) (currently AS No. 18), *Related Parties* (AS 2410); and
- ▶ the firms' use of software audit tools to perform substantive testing and risk assessment procedures.

⁸ See page 6 of PCAOB Staff Inspection Brief 2016-03.

⁹ As discussed in the PCAOB Staff Inspection Brief 2016-01.

Improving Transparency through Disclosure of Engagement Partner and Certain Other Participants in Audits: PCAOB Rules 3210 and 3211.

In May of 2016, the SEC approved PCAOB [Rule 3210, Amendments and Rule 3211, Auditor Reporting of Certain Audit Participants](#). Registered public accounting firms will be required to file with the PCAOB a new form, Form AP, *Auditor Reporting of Certain Audit Participants*. The information reported on Form AP will be available publicly in a searchable database on the PCAOB's website. The new rules of the Board and amendments to auditing standards will take effect as follows:

- ▶ engagement partner identification: auditors' reports issued on or after January 31, 2017; and
- ▶ other accounting firms: auditors' reports issued on or after June 30, 2017.¹⁰

Form AP will be required to be filed by the 35th day after the date the audit report is first included in a document filed with the SEC (e.g., Form 10-K), with a shorter 10-day filing deadline that applies when the audit report is first included in a Securities Act registration statement (e.g., Form S-1).

Firms will have to assign a unique 10-digit Partner ID to all engagement partners responsible for the firm's issuance of an issuer audit report. This ID will be comprised of the firm's ID (a unique five-digit identifier based on the number assigned to the firm by the PCAOB at the time of a firm's registration) and a unique five-digit partner identifier created by the firm.

EXTENT OF PARTICIPATION OF OTHER ACCOUNTING FIRM(S)

If the responsibility for the audit is divided with one or more public accounting firm(s), the firm filing Form AP will disclose the legal name of the other firm, its firm ID (when applicable), city and state (or, if outside the United States, city and country) of the office of the other firm that issued the other audit report and the magnitude¹¹ of the portion of the financial statements audited by the other firm. In disclosing the magnitude, Form AP requires disclosure of only one measure.

If the responsibility for the audit is not divided with one or more public accounting firm(s), the firm filing Form AP will disclose for each other firm named on Form AP the legal name, city and state (or, if outside the United States, city and country) of the headquarters' office, the other accounting firm's firm ID (if applicable) and

- ▶ the extent of participation¹² of other accounting firm(s) that took part in the audit, if their work constituted five percent or more of the total audit hours; and
- ▶ the number and aggregate extent of participation of all other accounting firm(s) that took part in the audit whose individual participation was less than five percent of the total audit hours.

The extent of other accounting firm(s') participation, expressed as a percentage of total audit hours, may be presented on Form AP as a single number or within the appropriate range of the percentage of hours (e.g., "10 percent to less than 20 percent of total audit hours"). For other accounting firm(s) whose extent of participation is five percent or more, the percentage of audit hours attributable to their participation should be calculated individually.¹³

¹⁰ See PCAOB Release 2015-008, VII Effective Date, at page 71.

¹¹ See Note to Item 5.1 of Form AP.

¹² Note to Item 3.2 of Form AP states that "an other accounting firm participated in the Firm's audit if (1) the Firm assumes responsibility for the work and report of the other accounting firm as described in paragraphs .03-.05 of AS 1205, *Part of the Audit Performed by Other Independent Auditors*, or (2) the other accounting firm or any of its principals or professional employees was subject to supervision under AS 1201, *Supervision of the Audit Engagement*."

¹³ See Note 1 to Item 4.1 of Form AP.

CALCULATION OF TOTAL AUDIT HOURS

For purposes of determining the extent of other accounting firm(s') participation, the firm issuing the audit report will calculate the total audit hours incurred in the most recent period's audit. Actual audit hours should be used if available. The auditor may also estimate total audit hours, documenting in its files consistent with [AS 1215](#) (currently AS No. 3), *Audit Documentation* (AS 1215), the reasonable method used to estimate hours and the computation of total audit hours. Total audit hours should be comprised of hours attributable to:

- ▶ the financial statement audit;
- ▶ reviews pursuant to [AS 4105](#), (currently AU sec. 722) *Reviews of Interim Financial Information* (AS 4105); and
- ▶ the audit of internal control over financial reporting pursuant to [AS 2201](#), (currently AS No. 5) *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 2201).

Hours incurred in the audit by entities other than other accounting firm(s) (e.g., shared service centers) are included in the calculation of total audit hours and should be allocated among the firm filing Form AP and the other accounting firm(s) participating in the audit on the basis of which accounting firm commissioned and directed the applicable work.

Excluded from Form AP disclosure and from total audit hours in the most recent period's audit are, respectively, the identity and hours incurred by:

- ▶ the engagement quality reviewer;
- ▶ the person who performed the review of an SEC filing pursuant to [SEC Practice Section 1000.45 Appendix K SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants](#); ¹⁴
- ▶ specialists engaged, not employed, by the Firm;
- ▶ an accounting firm performing the audit of entities in which the issuer has an investment that is accounted for using the equity method;
- ▶ internal auditors, other company personnel, or third parties working under the direction of management or the audit committee who provided direct assistance in the audit of internal control over financial reporting; and
- ▶ internal auditors who provided direct assistance in the audit of the financial statements.

PCAOB RESOURCES

To help accounting firms implement the new rules, in June of 2016 the PCAOB issued [Staff Guidance](#) on Form AP, *Auditor Reporting of Certain Audit Participants and Related Voluntary Audit Report Disclosure under AS 3101*, ¹⁵ *Reports on Audited Financial Statements*. The PCAOB also launched [a web resource page](#) on Form AP for investors, auditors, and others interested in information about the new rules. The page provides a [Sample Form AP, as well as instructions on how to submit Form AP via XML](#) and the [Form AP XML Schema](#). We encourage our members to review these useful resources in preparation for their reporting on Form AP in 2017.

¹⁴ Such reviews are limited to registration statements, annual reports on Form 20-F and 10-K, and other SEC filings that include or incorporate the foreign associated firm's audit report on the financial statements of an SEC registrant.

¹⁵ Currently AU sec. 508, *Reports on Audited Financial Statements*.

COMMUNICATION WITH AUDIT COMMITTEES

While Rule 3211 has no incremental requirements with respect to communications to the audit committee, auditors may consider briefing the audit committee on Rule 3211 and its associated requirements for the auditor. AS 1301 (currently AS No. 16), *Communications with Audit Committees*, provides existing requirements with respect to the auditor communications with the company's audit committee.

Improper Alteration of Audit Documentation

PCAOB [Practice Alert No. 14](#), *Improper Alteration of Audit Documentation* (Practice Alert No. 14) addresses improper alteration of audit documentation in circumstances when the auditors are subject to PCAOB inspection or investigation. The practice alert emphasizes the possibility of severe disciplinary consequences for improperly altering audit documentation in connection with a PCAOB inspection or investigation.

PCAOB [Rule 4006](#), *Duty to Cooperate with Inspectors*, requires that “every registered public accounting firm, and every associated person of a registered public accounting firm...cooperate with the Board in the performance of any Board inspection.” This duty to cooperate includes an obligation not to provide improperly altered documents or misleading information in connection with the Board's inspection processes.

[AS 1215](#) contains the procedures and time frames for auditors to follow with respect to audit documentation. It also requires auditors to “have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report”¹⁶ prior to the audit report release date. The auditing standard states that “audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached.”¹⁷

Audit documentation should be finalized not more than 45 days after the auditor's report release date (“documentation completion date”). AS 1215 states that, “audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.”¹⁸

- ▶ Practice Alert No. 14 encourages firms to self-report suspected audit documentation alterations either directly or anonymously:
 - ▶ to staff in the Division of Registration and Inspections;
 - ▶ to staff in the Division of Enforcement and Investigations;
 - ▶ to the PCAOB Tip and Referral Center; or
 - ▶ using an accounting firm's internal whistleblower and complaint systems.

Effective Communication with Audit Committees

Auditors should continue to focus on their communication with audit committees. Preliminary 2015 PCAOB inspection results indicate certain deficiencies in communication related to the overall audit strategy, timing of the audit, and all of the significant risks the firms had identified.¹⁹

Auditor's should refer to PCAOB [Rule 3526](#), *Communication with Audit Committees Concerning Independence*, and [AS 1301](#) (currently AS No. 16), *Communications with Audit Committee* (AS 1301). In addition, Appendix B of AS 1301, *Communications with*

¹⁶ AS 1215.15.

¹⁷ AS 1215.04.

¹⁸ AS 1215.16.

¹⁹ See page 10, PCAOB Staff Inspection Brief 2016-01.

Audit Committees Required by Other PCAOB Rules and Standards identifies other PCAOB rules and standards related to the audit that require communication of specific matters by the auditor to the audit committee.

The standard encourages effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit with the objectives of the auditor to:

- ▶ “communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;
- ▶ obtain information from the audit committee relevant to the audit;
- ▶ communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and
- ▶ provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.”²⁰

As a reminder to our member firms, the auditor is required to, among other things:

- ▶ Communicate to the audit committee concerning independence. Rule 3526 requires the auditor to provide annually to the audit committee a written description of relationships that “may reasonably be thought to bear on independence.”
- ▶ Communicate to the audit committee, as required by the PCAOB [Rule 3524](#), *Audit Committee Pre-approval of Certain Tax Services*, the scope of tax services, and the potential effect of all tax services on the independence of the firm.
- ▶ Communicate to the audit committee, as required by the PCAOB [Rule 3525](#), *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*, in connection with seeking pre-approval to perform any permissible non-audit service related to internal control over financial reporting.
- ▶ Inquire of the audit committee, management, and others within the company about the risks of material misstatement, including fraud risks.²¹
- ▶ Communicate an overview of the overall audit strategy; timing of the audit; and all of the significant risks the firm has identified during the auditor’s risk assessment procedures.²² In addition, the auditor could consider focusing a portion of their discussion on certain audit risks most applicable to the issuer, including revenue due to the presumed fraud risk, income taxes, emerging markets in foreign locations, and mergers and acquisitions.²³
- ▶ Communicate situations in which, as a result of the auditor’s procedures, the auditor identified a concern regarding management’s anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.²⁴
- ▶ Communicate, where applicable, matters relating to the auditor’s evaluation of the company’s ability to continue as a going concern,²⁵ including whether the firm believes there is substantial doubt about the issuer’s ability to continue as a going concern.²⁶

²⁰ AS 1301.03.

²¹ See AS 2110.05.f. and AS 2110.54 –.57.

²² AS 1301.09 –.11

²³ See page 5 of PCAOB Release No. 2016-001.

²⁴ AS 1301.13.f.

²⁵ AS 1301.17.

²⁶ AS 1301.17.a.

Assessing and Responding to Risks of Material Misstatement

In October of 2015, the PCAOB issued [Release No. 2015-007](#), *Inspection Observations Related to PCAOB “Risk Assessment” Auditing Standards (No. 8 through No. 15)* (PCAOB Release No. 2015-007). PCAOB Release No. 2015-007 provides observations regarding the implementation of and compliance with the PCAOB’s Risk Assessment Auditing Standards,²⁷ based on findings from the 2012–2014 PCAOB inspections. PCAOB Release No. 2015-007 also provides insight into potential root causes of these deficiencies and potential remedial actions that firms may consider.

To strengthen audit quality, the auditor should continue to focus on the application of [AS 2301](#) (currently AS No. 13), *The Auditor’s Responses to the Risks of Material Misstatement* (AS 2301), [AS 2810](#) (currently AS No. 14), *Evaluating Audit Results* (AS 2810), [AS 1105](#) (currently AS No. 15), *Audit Evidence* (AS 1105), and other risk assessment auditing standards, including [AS 2110](#) (currently AS No. 12), *Identifying and Assessing Risks of Material Misstatement* (AS 2110). In the following sections we remind our member firms of some of the requirements of certain Risk Assessment Auditing Standards, as discussed in the PCAOB Release No. 2015-007.

THE AUDITOR’S RESPONSES TO THE RISKS OF MATERIAL MISSTATEMENT

AS 2301 establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.²⁸ To meet the objectives set forth in this standard, the audit responses must address the risks of material misstatement that are identified and assessed in accordance with AS 2110.²⁹

AS 2301 establishes requirements regarding testing and evaluating controls in an audit of financial statements. AS 2301 requires that, if the auditor plans to assess control risk at less than the maximum by relying on controls, and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.³⁰ Auditors often rely on controls to reduce their substantive testing of financial statement accounts and disclosures. Consequently, deficiencies in testing and evaluating internal control may lead to inadequate testing of accounts and disclosures, for example:

- ▶ the level of control reliance may not be supported, and the sample sizes may be too small to provide sufficient evidence to meet the objectives of the test; and
- ▶ insufficient substantive procedures may be performed, when the auditor elects an inappropriate controls reliance approach.

The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.³¹ As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases.³² The auditor should perform substantive procedures, including tests of details, that are specifically responsive to fraud risks and other significant risks identified.³³

AUDIT EVIDENCE

AS 1105 explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient, appropriate audit evidence.³⁴ When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to (1) test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information, and (2) evaluate whether the information is sufficiently precise and detailed for the purposes of the audit.³⁵

²⁷ These standards include AS 1101, AS 2101, AS 1201, AS 2105, AS 2110, AS 2301, AS 2810, AS 1105 (currently AS 8 – AS 15).

²⁸ AS 2301.01.

²⁹ AS 2301.03.

³⁰ AS 2301.16.

³¹ AS 2301.36.

³² AS 2301.37.

³³ AS 2301.11 and .13.

³⁴ AS 1105.01.

³⁵ AS 1105.10.

Auditors sometimes select specific items for testing based on a specified characteristic, such as key items or items reflecting transactions over a certain amount.³⁶ Such a selection approach can allow the auditor to focus testing on items that are important to the objective of the test. However, that approach does not involve audit sampling, and the results of that testing cannot be projected to the remaining items in the account or class of transactions.³⁷

EVALUATING AUDIT RESULTS

AS 2810 establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.³⁸ The auditor is required to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, including whether the financial statements contain the information essential for a fair presentation in conformity with that framework.³⁹ Also, the auditor is required to conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements.⁴⁰

In forming an opinion on whether the financial statements are presented fairly, in all material respects, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements.⁴¹ If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.⁴²

Internal Control over Financial Reporting (ICFR)

TRANSITION TO THE NEW REVENUE RECOGNITION STANDARD

In May of 2014, the FASB adopted [ASU No. 2014-09](#), *Revenue from Contracts with Customers*, (the new revenue recognition standard or ASU No. 2014-09), which will be effective for calendar year-end public companies in 2018. While the audit requirements have not changed as a result of the issuance of the new revenue standard, issuers should start focusing on the implementation process in 2016. Revenue arrangements with tiered pricing, rights of return, volume discounts and other marketing offers, and contract modifications, among other factors, may require careful evaluation under the new standard.

The new revenue recognition standard provides several transition options including full retrospective, retrospective with several available practical expedients, and cumulative catch up methods of adoption. For issuers choosing the full retrospective option for adopting the new standard, the transition period has already begun. For example, after the standard's effective date, an issuer with a calendar fiscal year end and who is not a smaller reporting company will present a three-year comparative income statement for fiscal years ending in 2016, 2017, and 2018. At that time, the historical revenue amounts will be restated to reflect revenue recognition under the new standard.

In a March 2016 [speech](#), SEC Chief Accountant James V. Schnurr acknowledged that implementation of the new revenue recognition standard will likely also impact ICFR, as issuers redesign or develop new business processes, systems and controls. Schnurr believes that a successful transition will largely depend on effective ICFR, particularly management review controls, which can involve significant judgment. He encouraged management to take a fresh look not only at the "historical accounting policies and how they may need to change, but also at the design of the related controls (both existing and new) to ensure they are designed to operate in a manner that is sufficiently sensitive or precise to prevent or detect a material misstatement in the financial statements." Schnurr also observed that, in addition to business process-level controls, it is also important to keep in mind the other components of internal control over financial reporting, including control environment and risk assessment. "For example, availability of competent resources trained to

³⁶ AS 1105.25 – .27.

³⁷ AS 1105.27.

³⁸ AS 2810.01.

³⁹ AS 2810.30 – .31.

⁴⁰ AS 2810.33.

⁴¹ AS 2810.03 and .34.

⁴² AS 1105.29.

exercise sound judgment will be essential to the consistent, reliable application of the new revenue recognition guidance.” Schnurr recommends that implementation status and plans should be discussed among the issuer’s executive management, its audit committee, and its auditor.

The auditor has a responsibility to evaluate whether the issuer’s presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework,⁴³ which includes the issuer’s evaluation of the effect the new revenue recognition standard will have on its financial statements. The auditor should also consider what information should be communicated to the issuer’s audit committee about the anticipated application of the new revenue recognition standard.⁴⁴

TESTING DESIGN AND OPERATING EFFECTIVENESS OF CONTROLS

In a [speech](#) given in August of 2016, PCAOB Board Member Jeanette M. Franzel recognized certain improvements for the U.S. Big Four firms in the number of deficiencies in testing design and operating effectiveness of controls. However, she expressed a concern over the selection of the appropriate controls to test stating that “in cases where the auditor has not properly identified important controls to test, the auditor doesn’t even get to the stage of testing the design and operating effectiveness of those controls.”

Based on provisions of [AS 2201](#), the auditor should identify and test controls or important aspects of controls (e.g., the criteria used by management to identify items for investigation and/or the resolution of such items) that address the specific risks of material misstatement that the auditor had identified.⁴⁵ Understanding a company’s internal control includes, among other things, understanding the information systems relevant to financial reporting (e.g., the procedures by which transactions are initiated, authorized, processed, recorded and reported), including the related business processes.⁴⁶

Auditors are encouraged to read [Staff Audit Practice Alert No. 11](#), *Considerations for Audits of Internal Control Over Financial Reporting*, (Practice Alert No. 11) for more information related to auditing internal control. [CAQ Alert 2015-07, Select Auditing Considerations for the 2015 Audit Cycle](#) (the 2015 CAQ Alert) provides additional reminders for member firms related to compliance with AS 2201 and Practice Alert No. 11.

INCOME TAX ACCOUNTING AND DISCLOSURE

Auditors are encouraged to focus on the procedures performed to test the design and operating effectiveness of controls selected for testing; and tests of controls and/or substantive tests over the valuation allowance of net deferred tax assets.

If material, the auditor would likely evaluate and test management’s assertion regarding the indefinite reinvestment of its earnings in foreign jurisdictions. This evaluation could include the impact of events, such as significant cash transfers from a foreign subsidiary to the U.S. parent. It is also important for the auditor to critically evaluate the design and operating effectiveness of controls related to income taxes,⁴⁷ including the testing of selected controls over the completeness and valuation of income taxes and the related financial statement disclosures.

Segment Identification and Disclosure

The SEC continues to focus on segment disclosures.⁴⁸ In a December 2015 [speech](#) at the AICPA Conference on Current SEC and PCAOB Developments, Helen A. Munter, Director of the PCAOB’s Division of Registration and Inspections, encouraged auditors to consider how an issuer identifies the chief operating decision maker (CODM) and determines its operating segments and its reportable segments. This evaluation would typically include considerations of whether any factors have arisen that would suggest a reassessment of segment reporting is necessary, including the analysis of the characteristics an issuer considers when deciding whether or not

⁴³ AS 2810.30 –.31.

⁴⁴ AS 1301.13.f.

⁴⁵ AS 2201.21 –.41.

⁴⁶ AS 2201.34 –.36.

⁴⁷ PCAOB Staff Inspection Brief 2016-03.

⁴⁸ Courtney D. Sachtleben, Professional Accounting Fellow, Office of the Chief Accountant, [Remarks](#) at the 2015 AICPA National Conference on Current SEC and PCAOB Developments.

operating segments can be aggregated.⁴⁹ FASB Accounting Standards Codification Topic 280, *Segment Reporting* (ASC 280) provides guidance on how to report certain information about operating segments in complete sets of financial statements of the issuer and in condensed financial statements of interim periods issued to shareholders. It also requires that issuers report certain information about their products and services, the geographic areas in which they operate, and their major customers.

The guidance on segment reporting requires financial statement preparers to apply reasonable judgments, including those needed in the determination of operating segments, aggregation, and entity-wide disclosures. When testing management's controls over segment disclosures, it is important to consider both controls over the preparation of these disclosures and controls over the monitoring of events that might require changes in segment determinations and disclosures from one period to the next.⁵⁰ The auditor should continue to focus on the design and operating effectiveness of management's controls over segment reporting.

Going Concern

The FASB [ASU No. 2014-15](#), *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* (ASU No. 2014-15) becomes effective for all companies for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. ASU No. 2014-15 requires management to assess a company's ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. Under the new standard, disclosures are required when conditions give rise to substantial doubt about a company's ability to continue as a going concern within one year from the financial statements issuance date (or within one year after the date that the *financial statements are available to be issued* when applicable). The ASU indicates that "substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). The term probable is used consistently with its use in Topic 450 on contingencies." The auditing literature provides qualitative factors for auditors to consider.

PCAOB staff has indicated in [Staff Audit Practice Alert No. 13](#), *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern* (Practice Alert No. 13) that the auditor's evaluation of whether substantial doubt exists is qualitative, based on the relevant events, conditions, and other considerations set forth in the auditing standards. Accordingly, management's determination that no disclosure is required under the provisions of ASU No. 2014-15 is not conclusive as to whether an explanatory paragraph is required in the auditor's report.

Paragraph 2 of [AS 2415](#) (currently AU sec. 341), *Consideration of an Entity's Ability to Continue as a Going Concern* (AS 2415) provides that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited..." Paragraph 3 of AS 2415 describes the manner in which the auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

When evaluating a company's ability to continue as a going concern, considerations of the company's operating performance, cash flow, the risk of debt defaults and other relevant factors may be taken into account. Paragraph 6 of AS 2415 provides examples of "certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time." Auditors should apply professional skepticism and consider all of the relevant facts,⁵¹ regardless of whether they support or contradict management's assertions.

49 <https://pcaobus.org/News/Speech/Pages/Munter-AICPA-2015-inspections-update.aspx>.

50 PCAOB Staff Inspection Brief 2016-03.

51 [Staff Practice Alert No. 10](#), *Maintaining and Applying Professional Skepticism in Audits* reminds auditors of a requirement to plan and perform his or her work with due professional care, which requires the auditor to exercise professional skepticism.

Additional Considerations for the 2016 Audit Cycle

The [2015 CAQ Alert](#) provides an overview of the relevant considerations for the auditors evaluating accounting estimates, including fair value, and addresses auditor's responsibility with respect to the audit risk related to cybersecurity and provisions of AS 2410, *Related Parties* (AS 2410). The information presented below is incremental to the discussion of these topics in the 2015 CAQ Alert.

ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE MEASUREMENTS

Fair value measurements and other accounting estimates involve the potential for management bias and require the auditor to apply professional skepticism when testing estimates. It is important for auditors to understand how estimates are developed, as well as test data and evaluate assumptions used by management that are significant to the estimate. Auditors are reminded not to limit their audit procedures to inquiry and to sufficiently evaluate and consider contradictory or potentially inconsistent information. Growing merger and acquisition activity presents additional audit risk due to increasing complexity of estimates related to growing deal values. This environment may increase the risk of improper valuation of assets acquired and liabilities assumed given the large deal sizes, complexity of the transactions and high degree of judgments associated with estimation of fair value.

CYBERSECURITY

Cybersecurity is a critical issue with potentially serious implications for public companies, their boards, investors, and other stakeholders. Cyber-incidents are occurring more frequently at entities of all sizes, resulting from both deliberate attacks and unintentional events.

As discussed in further detail in our [CAQ Alert No. 2014 -03, *Cybersecurity and the External Audit*](#), the responsibility of the independent auditor with respect to cybersecurity relates to the audit of the financial statements and, when applicable, the audit of ICFR. The financial reporting-related information technology (IT) systems and data that may be in scope for the external audit usually are a subset of the aggregate systems and data used by companies to support their overall business operations and may be separately managed or controlled. Accordingly, the financial statement and ICFR audit responsibilities do not encompass an evaluation of cybersecurity risks across a company's entire IT platform.

In the event of a cyber-incident, the auditor is responsible for evaluating a company's accounting for known cybersecurity related losses and for assessing the impact on a company's financial statements and disclosures,⁵² including items such as contingent liabilities or claims, as they relate to the audit of the financial statements taken as a whole and the impact on ICFR. As it relates to ICFR, the auditor would also be responsible for assessing the company's controls related to timely recording and disclosing the necessary information in the financial statements.

AUDITOR INDEPENDENCE

Certain PCAOB inspections identified instances where impermissible non-audit services were provided as well as deficiencies in the area of personal independence, principally with respect to financial relationships. The PCAOB has also observed instances where certain partners have violated the five-year rotation requirement and served as the engagement partner or engagement quality review partner longer than a five-year period or sometimes within the five-year period following having served for five consecutive years.⁵³ Continuing to serve as the engagement partner or engagement quality review partner performing audit or review procedures for financial statements for quarterly periods after the fifth consecutive year may constitute a violation of the SEC independence rules.⁵⁴

It is important for auditors to focus on compliance with auditor independence requirements, including evaluation of firms' systems of quality control, encompassing its policies and procedures for monitoring and maintaining independence. We refer our member firms to additional considerations provided in the Effective Communication with Audit Committees section above regarding required communication of auditor independence, tax services and other relevant matters.

⁵² The SEC [CF Disclosure Guidance: Topic # 2 Cybersecurity](#) provides disclosure guidance and accounting reminders to the issuer's management about cybersecurity matters.

⁵³ Speech by Helen A. Munter, Director of the PCAOB's Division of Registration and Inspections, 2015 AICPA Conference on Current SEC and PCAOB Developments and PCAOB Staff Inspection Brief 2016-01.

⁵⁴ See Rule 2-01(c)(6)(i) of Regulation S-X.

IMPLEMENTATION OF AS 2410 RELATED PARTIES

[AS 2410](#) has been effective for audits of fiscal years beginning on or after December 15, 2014. It is important for firms to continue to focus on how their systems of quality control promote enhancements to audit methodology and other guidance, tools and templates relating to this new auditing standard, as well as overall compliance with AS 2410.

FIRM SOFTWARE AUDIT TOOLS

Some firms are developing and using software audit tools to provide opportunities to perform audit work more effectively and efficiently. Some firms use various purchased, customized or internally developed software audit tools. Such software audit tools are being used to perform substantive audit procedures and may also be used to assist the auditor with completing his or her risk assessment.

As a result of increased use of technology, audit firms may want to consider if the systems of quality control currently in place provide assurance that (1) the tools used to analyze the data meet the audit objectives, (2) engagement teams are effectively using these tools and properly evaluating the results of screening large data populations, and (3) engagement teams are applying due care, including professional skepticism, when using these tools to perform audit procedures, including the evaluation of results of that work.

References

References to applicable PCAOB rules and other publications cited in the 2016 CAQ Alert are provided below:

- ▶ [Rule 3210, Amendments](#) and [Rule 3211, Auditor Reporting of Certain Audit Participants](#);
- ▶ The PCAOB [Release No. 2015-008](#) *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*;
- ▶ PCAOB [Rule 4006](#), *Duty to Cooperate with Inspectors*;
- ▶ PCAOB [Rule 3526](#), *Communication with Audit Committees Concerning Independence*;
- ▶ PCAOB [Rule 3524](#), *Audit Committee Pre-approval of Certain Tax Services*;
- ▶ PCAOB [Rule 3525](#), *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*;
- ▶ PCAOB [Staff Practice Alert No. 10](#), *Maintaining and Applying Professional Skepticism in Audits*;
- ▶ PCAOB [Staff Audit Practice Alert No. 11](#), *Considerations for Audits of Internal Control Over Financial Reporting*;
- ▶ PCAOB [Staff Audit Practice Alert No. 13](#), *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern*;
- ▶ PCAOB [Staff Audit Practice Alert No. 14](#), *Improper Alteration of Audit Documentation*;
- ▶ PCAOB [Release No. 2015-007](#), *Inspection Observations Related to PCAOB "Risk Assessment" Auditing Standards (No. 8 through No.15)*;
- ▶ PCAOB [Release No. 2015-008](#) *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*;
- ▶ PCAOB [Release No. 2016-001](#), *Inspection Observations Related to PCAOB Rules and Auditing Standards on Communications with Audit Committees*;
- ▶ PCAOB Staff Inspection Brief, [Vol. 2016/1: Preview of Observations from 2015 Inspections of Auditors of Issuers](#);
- ▶ PCAOB Staff Inspection Brief, [Vol. 2016/3: Information about 2016 Inspections](#);
- ▶ PCAOB [Staff Guidance](#) on Form AP, *Auditor Reporting of Certain Audit Participants and Related Voluntary Audit Report Disclosure under AS 3101, Reports on Audited Financial Statements*;
- ▶ PCAOB [instructions on how to submit Form AP via XML](#);
- ▶ [Sample Form AP](#);
- ▶ [Form AP XML Schema](#);
- ▶ Wesley R. Bricker, SEC Interim Chief Accountant, [Remarks](#) before the AICPA National Conference on Banks & Savings Institutions;
- ▶ James V. Schnurr, SEC Chief Accountant, Office of the Chief Accountant, [Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress](#);
- ▶ Courtney D. Sachtleben, Professional Accounting Fellow, Office of the Chief Accountant, [Remarks](#) at the AICPA National Conference on Current SEC and PCAOB Developments;
- ▶ Jeanette M. Franzel, PCAOB Board Member, [Update on Trends and Issues in Audits of Internal Control over Financial Reporting](#);
- ▶ Helen A. Munter, Director of the PCAOB's Division of Registration and Inspections, 2015 AICPA Conference on Current SEC and PCAOB Developments, [The State of Audit Quality](#);
- ▶ FASB ASU [No. 2014-09](#), *Revenue from Contracts with Customers*;
- ▶ FASB ASU [No. 2016-02](#), *Leases (Topic 842)*;
- ▶ FASB ASU [No. 2016-13](#) *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses in Financial Instruments*;
- ▶ FASB [ASU No. 2014-15](#), *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*;
- ▶ [CAQ Alert No. 2014-03](#), *Cybersecurity and the External Audit*;
- ▶ [CAQ Alert No. 2015-07](#), *Select Auditing Considerations for the 2015 Audit Cycle*; and
- ▶ The SEC [CF Disclosure Guidance: Topic # 2 Cybersecurity](#).