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Select Auditing Considerations for the 2013 Audit Cycle

This Alert is intended to remind member firms of certain auditing considerations that may be relevant for the 2013 audit cycle. The Alert identifies and discusses some of the more judgmental or complex audit areas, including those which have recently been the subject of attention and focus by regulators. While the Alert highlights certain areas for consideration, it should not be relied upon as definitive or all inclusive, and should be read together with the applicable rules, standards, and guidance in their entirety. The CAQ encourages member firms to consider the topics addressed in this Alert in executing their 2013 audits.

This Alert covers the following auditing considerations:

1. Internal Control Over Financial Reporting
2. Professional Skepticism
3. Engagement Quality Review
4. Accounting Estimates, Including Fair Value Measurements
5. Substantive Analytical Procedures
6. Inaccurate or Omitted Disclosures

Internal Control Over Financial Reporting

The Public Company Accounting Oversight Board (PCAOB) issued Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting* (Practice Alert No. 11)[1], in October 2013. Practice Alert No. 11 highlights certain requirements of the PCAOB's auditing standards relating to aspects of audits of internal control over financial reporting cited frequently in PCAOB inspection reports. Practice Alert No. 11 focuses on seven topical areas related to the audit of internal control over financial reporting that are briefly summarized below:

- Risk assessment and the audit of internal control over financial reporting: Risk assessment is a key element of the top-down approach and it underlies the entire audit process in the audit of internal control over financial reporting. Understanding the flow of transactions and identifying the risks of material misstatement – including the types of potential misstatements that can occur and the likely sources of those potential misstatements – is necessary for the auditor to select appropriate controls to test and to evaluate whether those controls adequately address the risks. Examples of areas to focus on include:

    - Considering whether review controls or other detective controls adequately address the risks of material misstatement
    - Obtaining an understanding of the likely sources of potential misstatements related to significant accounts or disclosures
    - Considering whether components of a significant account or disclosure are subject to different risks; therefore, the auditor may need to select and test different controls to support a conclusion that the controls adequately address the risks to the account or disclosure

[1] See PCAOB alert at http://pcaobus.org/Standards/QandA/10-24-2013_SAPA_11.pdf.

  - Considering the risks of material misstatement to the consolidated financial statements associated with a location or business unit in a multi-location audit and evaluating whether the company's systems and controls were designed and implemented consistently across multiple locations

- Selecting controls to test: The auditor should select controls that, individually or in combination, are intended to address the identified risks of material misstatement. This includes selecting controls that address the relevant assertions and the components of the account or disclosure with differing risks. Some risks, including those related to complex processes or subjective estimates, may require a combination of controls to prevent or detect misstatements. Also, selecting controls to test applies to routine, as well as, infrequent processes, such as analysis of whether long-lived assets are impaired, and to nonrecurring transactions, such as a material business combination.

  Additionally, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (AS 5), requires that a control must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control is effective because no misstatements were detected by substantive procedures.

- Testing management review controls: Auditors often select and test management review controls in audits of internal control over financial reporting. As with other types of controls, the auditor should perform procedures to obtain evidence about how a management review control is designed and operates to prevent or detect misstatements.

  Some management review controls operate at a level of precision that would adequately prevent or detect material misstatements on a timely basis. Factors that can affect the level of precision include the following:

  - Objective of the review control
  - Level of aggregation or disaggregation
  - Consistency of performance
  - Correlation to relevant assertions
  - Predictability of expectations
  - Criteria for investigation

  In addition to assessing precision, evaluating the design of a management review control generally involves obtaining an understanding and evaluating the following:

  - Whether the control satisfies the corresponding control objective
  - Steps involved in identifying, investigating and resolving significant differences from expectations
  - Competence and authority of those performing the control
  - Frequency of performance of the control
  - Information used in the review

  Verifying that a review was signed off provides little or no evidence by itself about the control's effectiveness. Testing operating effectiveness typically involves evaluating evidence about the steps performed to identify and investigate significant differences and conclusions reached in the reviewer's investigation. The assessment of the sufficiency of management's documentation may also be important to allow the auditor to properly evaluate the performance and effectiveness, reliance on inquiry of management alone is not sufficient.

- <u>Information technology (IT) considerations, including system-generated data and reports:</u> PCAOB standards require the auditor to obtain an understanding of the company's information technology systems relevant to financial reporting and take IT considerations into account in assessing the risks of material misstatement. This includes obtaining an understanding of the extent of manual controls and automated controls used by the company, including the information technology general controls (ITGCs) that are important to the effective operation of the automated controls. The auditor also should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. If a control selected uses system-generated data or reports, the effectiveness of the control depends, in part, on the controls over the accuracy and completeness of the system-generated data or reports. In that situation, assessing the effectiveness of the selected control would involve testing both the selected control and the controls over the system-generated data and reports. The existence of control deficiencies in ITGCs may, however, impact the auditor's ability to conclude on the effectiveness of the IT-dependent control, as well as affect the nature and extent of controls identified over such data and reports.

- <u>Roll-forward of controls tested at an interim date:</u> Although the auditor expresses an opinion on internal control over financial reporting as of a specific date, auditors may decide to test some important controls during the year. When auditors test controls at an interim date, PCAOB standards require auditors to perform roll-forward procedures to update the results of interim testing through the as of date of the report. In developing the roll-forward procedures, the auditor may consider among other items, such factors as significance of the risks related to the control, length of the roll-forward period, and extent of testing at an interim date.

- <u>Using the work of others:</u> PCAOB standards allow the auditor to use the work of others (e.g., internal audit) as evidence of the effectiveness of selected controls, and AS 5 requires auditors to evaluate the extent to which the work of others will be used. PCAOB standards provide that the extent to which the work of others can be used depends on the risk associated with the control being tested and the competence and objectivity of the persons whose work the auditor plans to use. The risk associated with the control is the risk that a control might not be effective and, if not effective, that a material weakness could result. As the risk associated with the control increases, the need for the auditor to perform his or her own testing of the control increases. When the auditor uses the work of others, the auditor also should test and evaluate that work, including evaluating the quality and effectiveness of the others' work.

- <u>Evaluating identified control deficiencies:</u> Control deficiencies might also be identified during the audit of the financial statements. PCAOB standards require auditors to evaluate whether misstatements detected by substantive procedures might alter the auditor's judgment about the effectiveness of controls. PCAOB standards also require auditors to evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies individually or in combination with other deficiencies, including control deficiencies that were identified with respect to the ITGCs are material weaknesses. For example, an IT control might not be intended to prevent or detect misstatements by itself but an IT control deficiency might impair the effectiveness of important IT-dependent controls across multiple accounts. Evaluating whether a control deficiency or a combination of control deficiencies, results in a material weakness requires professional judgment and a careful analysis of the evidence obtained, including consideration of misstatements identified as well as, assessment of the potential magnitude of misstatement.

Auditors are encouraged to read Practice Alert No. 11, as well as AS 5, for a more thorough examination of each of the above topics.

Professional Skepticism

The auditor is required to plan and perform his or her work with due professional care, which requires the auditor to exercise professional skepticism. The PCAOB issued Staff Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits*[2], in December 2012, certain aspects of which are discussed below.

PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. As a result, professional skepticism should be exercised throughout the audit process, including in the areas discussed above and in those areas of the audit that involve significant management judgments, and transactions that are outside the normal course of business, and as it relates to the auditor's consideration of fraud in an audit. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. The engagement partner is responsible for, among other things, setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations. The engagement partner and other senior engagement team members should also be involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention, such as unusual matters or inconsistencies in audit evidence, are identified and addressed appropriately.

Professional skepticism involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence rather than merely obtaining the most readily available evidence to corroborate management's assertions, and critically evaluating all evidence regardless of whether it corroborates or contradicts management's assertions. The following are examples of audit procedures in the PCAOB standards that reflect the need for professional skepticism:

- Resolving inconsistencies in or doubts about the reliability of confirmations
- Examining journal entries and other adjustments for evidence of possible material misstatements due to fraud
- Reviewing accounting estimates for biases that could result in material misstatements due to fraud
- Evaluating the business rationale for significant unusual transactions

[2] See PCAOB alert at http://pcaobus.org/Standards/QandA/12-04-2012_SAPA_10.pdf.

- Evaluating whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time

The auditor exercises professional skepticism in evaluating audit results. Examples of areas in the evaluation that reflect the need for the auditor to exercise professional skepticism include:

- Evaluating whether uncorrected misstatements result in material misstatement of the financial statements
- Evaluating potential management bias, such as in accounting estimates and the selection and application of accounting principles
- Evaluating whether the financial statements include the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework

Engagement Quality Review

On December 6, 2013, the PCAOB released a report on registered audit firms' implementation and compliance with Auditing Standard No. 7, *Engagement Quality Review* (AS 7)[3]. The PCAOB found that, while firms' methodologies generally were consistent with the requirements of AS 7, they did not always result in an appropriately executed engagement quality review. The report notes that in a number of engagements in which the PCAOB inspections staff identified audit deficiencies, the audit deficiency should have been identified by the engagement quality reviewer.

In addition to the supervision and review provided by the engagement partner and other senior engagement team members, the engagement quality reviewer also plays an important role in execution of an audit in accordance with PCAOB standards. In particular, the engagement quality reviewer, pursuant to AS 7 is required to perform specific procedures to evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the audit report.

The specific procedures identified in AS 7 include:

- Evaluating the significant judgments that relate to engagement planning, the identification of significant risks, and audit responses to those risks
- Reviewing the engagement team's evaluation of the audit firm's independence
- Evaluating the significant judgments made about (1) the materiality and disposition of corrected and uncorrected misstatements and (2) the severity and disposition of identified control deficiencies
- Reviewing the engagement completion document, confirming with the engagement partner that there are no significant unresolved matters
- Reviewing of the financial statements and related reports (e.g., management's report on internal control)
- Reading the other information in documents containing the financial statements to be filed with the Securities and Exchange Commission (SEC), and evaluating whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware

[3] See PCAOB report at http://pcaobus.org/Inspections/Documents/120613_EQR.pdf

- Based on these procedures, the engagement quality reviewer should also evaluate if appropriate consultations have occurred on difficult or contentious matters, whether the conclusions relating to such matters have been appropriately documented, and whether appropriate matters have been communicated, or identified for communication to the audit committee, management, and other parties

The responsibilities of the engagement quality reviewer should be carried out with objectivity and the application of due care, with the firm appropriately addressing the reviewer's findings before issuing the audit report. Moreover, documentation of an engagement quality review should contain sufficient information to enable an experienced auditor, having no previous connection with an engagement, to understand the procedures performed by the engagement quality reviewer to comply with AS 7.

Accounting Estimates, Including Fair Value Measurements

The auditor is responsible for evaluating how accounting estimates, which could be material to the financial statements have been developed; assessing the reasonableness of accounting estimates made by management in the circumstances; and assessing whether they are presented in conformity with applicable accounting principles and are appropriately disclosed. Examples of management estimates may include, among others, those related to the fair value of investments, allowances for doubtful accounts and loan losses, and uncertain tax positions.

When issuing an opinion on internal control over financial reporting or relying on internal controls in a financial statement audit, the auditor is responsible for testing the relevant internal controls related to significant estimates. When evaluating and testing management's control(s) over an accounting estimate, relevant aspects include:

- The reliability of underlying data used by management in developing the estimate
- Preparation of the accounting estimate by qualified personnel, and whether management has engaged an external specialist to assist in the development of the accounting estimate
- Adequate review and approval of the estimates including, for example, sources of relevant factors and the development of assumptions
- Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates
- Consideration by management of whether the resulting accounting estimate is consistent with the operational plans of the entity

For the financial statement audit, in evaluating the reasonableness of management's estimates, the auditor should obtain an understanding of how management developed the estimate and based upon that understanding, use one, or a combination of the following approaches[4]:

- Review and test the process used by management to develop the estimate. For example, testing management's goodwill impairment assessment would include reviewing and testing relevant assumptions inherent in management's process such as forecasted cash flow information or the discount rate used

[4] AU Section 342, *Auditing Accounting Estimates*, paragraph 10.

- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate. For example, developing an expected fair value for a financial instrument by using an auditor-developed model and comparing it to management's estimate of fair value. When using this approach, the auditor also obtains an understanding of the process used by management to develop the estimate
- Review subsequent events or transactions occurring prior to the date of the auditor's report

In evaluating the reasonableness of an estimate, the auditor normally focuses on key inputs and assumptions that are:

- Significant to the accounting estimate
- Sensitive to variations
- Deviations from historical patterns
- Subjective and susceptible to misstatement and bias

Additionally, the auditor generally should consider historical experience of the entity in making past estimates as well as the auditor's experience in the industry. After auditing each accounting estimate individually, the auditor should consider the accounting estimates in the aggregate in order to evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management.

A retrospective review is required of significant accounting estimates reflected in the financial statements of the prior year to determine whether management's judgments and assumptions related to the estimates indicate a possible bias on the part of management. This review will also inform the auditor on estimation uncertainty or other historical difficulties encountered.

Substantive Analytical Procedures

The auditor may choose to perform substantive analytical procedures as part of the overall testing approach related to certain assertions for a significant account. Among other financial statement areas, these may include certain assertions related to: revenue, depreciation expense, payroll expense, and interest income and expense. Substantive analytical procedures may be effective tests for relevant assertions related to accounts for which: (i) potential misstatements would not be apparent from an examination of the detailed evidence; or (ii) detailed evidence is not readily available. However, substantive analytical procedures may not always be effective in providing the appropriate level of assurance. For example, for significant risks of material misstatement it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient[5]. For such significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks[6].

If the overall testing approach includes substantive analytical procedures, the auditor should determine whether there are plausible and predictable relationships amongst the data used in the analytic. It is important for the auditor to understand the reasons that make the relationships' plausible and predictable, as data sometimes can appear to be related when there is no relationship. If the auditor is comfortable with the

[5] AU Section 329, *Substantive Analytical Procedures*, paragraph 9.
[6] Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* paragraph 11.

plausibility and predictability of the relationships and the reliability of the data used in performance of the substantive analytical procedure, the execution and documentation of the substantive analytical procedure should include the following:

- Precision of the expectation: The precision of the expectation should coincide with the desired level of assurance such that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified. For example, the more the data used in the substantive analytical procedure is disaggregated and detailed, the more precise it might be in detecting material misstatements.

- Investigation and evaluation of significant differences: In planning the analytical procedure, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. The threshold is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedure. For example, the more disaggregated the substantive analytical procedure is, the smaller the acceptable difference without investigation should be.

- Any additional auditing procedures performed in response to significant unexpected differences: The auditor should evaluate differences that are outside the accepted threshold established above. This would generally include obtaining sufficient evidence to corroborate management responses.

Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of the controls over financial information used in the substantive analytical procedures or perform other procedures over the completeness and accuracy of the underlying information. Each element of the substantive analytical procedure should be documented in the audit workpapers including the auditor's expectation.

Inaccurate or Omitted Disclosures

The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes matters such as the terminology used, the amount of detail given, the classification of items in the financial statements and the basis of amounts set forth. The evaluation also includes the form, arrangement, and content of the financial statements, including the accompanying notes, as well as, consideration of consistency with other information presented outside the financial statements (e.g. MD&A). The results of this evaluation should be considered and communicated to management or the audit committee, as appropriate, including the impact on the assessment of internal controls over financial reporting.