

CHAPTER 2 – IMPROVING THE CONDUCT OF AUDITS

2.1 This chapter discusses the profession’s standards that provide guidance on how audits of financial statements should be conducted, the Panel’s findings on how those audits actually are conducted and the Panel’s recommendations for improving the conduct of audits. Because of their importance, Chapter 3 is devoted in its entirety to the Panel’s analysis, findings and recommendations regarding earnings management and fraud.

OVERVIEW

2.2 This section provides an overview of the audit risk model, explains the Panel’s Quasi Peer Review (QPR) approach to assessing the effectiveness of audits, states the Panel’s broad conclusions and presents its framework for developing recommendations to improve the quality of audits.

The Audit Risk Model

2.3 Starting in 1948, the membership of the American Institute of Certified Public Accountants (AICPA) adopted 10 statements referred to as “generally accepted auditing standards” (GAAS). The Auditing Standards Board (ASB), a senior technical committee of the AICPA, has been assigned the responsibility for amplifying and interpreting the 10 GAAS through pronouncements called Statements on Auditing Standards (SASs). The SASs and the 10 GAAS statements frequently are referred to collectively as generally accepted auditing standards.

2.4 GAAS fall into three broad areas: general standards (dealing with the professional qualities of auditors, including technical training and proficiency, independence and the exercise of due professional care), standards of fieldwork (dealing with planning and supervision, internal control, and sufficiency and competency of audit evidence), and standards of reporting (dealing with how GAAS are linked to “generally accepted accounting principles” (GAAP) and the consistent application of GAAP, the adequacy of disclosures in financial statements and the expression of opinions in audit reports).

2.5 The ASB has established a formal process for developing standards, including subjecting them to public scrutiny prior to issuance. Rule 202 of the AICPA’s Code of Professional Conduct requires AICPA members to adhere to GAAS. Adherence to GAAS also is required of auditors by state accountancy laws and the Securities and Exchange Commission (SEC). Consequently, GAAS apply to all audits, not just to audits of financial statements of public entities.

2.6 United States auditing standards, which reputedly are the most comprehensive and demanding auditing standards in the world, generally call for auditors to achieve certain goals or objectives in carrying out an audit. In some cases, the standards require auditors to perform specified tasks (e.g., assess risk). In other cases, they require auditors only to consider attendant

circumstances in deciding what to do. They typically allow wide latitude for auditors to exercise judgment. This flexibility is understandable. The standards are designed for audits of financial statements of large and small entities in all industries, and they are premised on auditors being professionals who possess the necessary skills and knowledge to make the required judgments.

2.7 GAAS include an “audit risk model” for carrying out audits that requires auditors to use their judgment in assessing risks, selecting an audit approach and deciding what tests to perform.¹ The model allows auditors to take a variety of circumstances into account in selecting the audit approach for a particular engagement. The model calls for auditors to have an understanding of the entity’s business and industry, the systems employed to process transactions, the quality of personnel involved in accounting functions, and the entity’s policies and procedures related to the preparation of financial statements. The model requires auditors to gain an understanding of an entity’s internal control to assess the risk that controls will fail to prevent or detect material financial statement error and fraud, and to test the effectiveness of those controls that the auditor intends to rely on in designing and performing substantive tests of the entity’s accounts. For example, if internal control over sales and accounts receivable is strong, the auditor might confirm a limited number of accounts receivable at an interim date and rely on the controls and certain other tests for updating the accounts to year end. Conversely, if controls are not strong, the auditor might confirm a larger number of accounts receivable, and do so at year end.

2.8 Based on the auditor’s assessment of various risks, supported by appropriate tests of controls, the auditor makes judgments about the kinds of evidence (from sources that are both internal and external to the entity’s organization) needed to support the audit opinion. On the one hand, GAAS set forth numerous requirements or matters that auditors should consider, such as an explicit requirement to assess the risk of fraud; on the other hand, the need to exercise professional judgment is embedded throughout GAAS.

The QPR Approach to Assessing Audit Effectiveness

2.9 The Quasi Peer Review undertaking was an important, but not the only, part of the Panel’s assessment of audit effectiveness.² The QPR reviewed the audits of 126 SEC public companies in 28 offices of the eight largest audit firms. The engagements were selected on the basis of risk profiles established by the Panel for the purposes of:

- Assessing the quality of the audit work performed in specific key areas
- Assessing whether the individuals who performed and reviewed the work had the necessary knowledge, skills and experience

¹ A complete discussion of the audit risk model is included in Appendix A. That discussion provides an overview of the model, a technical briefing about it and a historical perspective about how the model evolved in GAAS. Also in Appendix A is a discussion about the audit methodologies used by audit firms to guide their work and how those methodologies have evolved over time.

² The QPR approach is discussed more fully in Appendix E.

- Assessing whether the work was performed appropriately and reviewed on a timely basis
- Developing ideas for enhancing audit effectiveness

2.10 The objectives and scope of the QPR differed from those of the peer review that a member of the SEC Practice Section (SECPS) of the AICPA must undergo triennially. The objectives of an SECPS peer review are to evaluate whether the reviewed firm's quality control system for its accounting and auditing practice met the objectives of the AICPA's quality control standards, and whether the firm complied with the system and with the SECPS membership requirements.³ The QPR's objective, on the other hand, was to make qualitative assessments of audit effectiveness on a sample of recent audit engagements. The QPR generally tracked key elements of the audit risk model, providing the basis for evaluating its efficacy.

2.11 The scope of the QPRs also differed from that of SECPS peer reviews. For example, the QPRs included more interviews with engagement personnel; they were limited to certain specific key areas of the audit; and no reports or letters of comments were issued. In the specific areas reviewed, however, the reviews were more in-depth and subjective.

2.12 The QPR results are discussed in this and the following chapter under the following headings:

- Assessing engagement risk
- Assessing inherent risk
- Multi-location audits
- Assessing control risk
- Communicating and reporting on internal control
- Linking the risk assessments to substantive tests
- Analytical procedures
- Auditing revenue
- Auditing estimates and judgments
- Materiality, waived adjustments and analysts' expectations
- Going concern considerations
- Internal auditors
- Communicating with audit committees
- Earnings management and fraud

2.13 For each engagement selected for review, the QPR reviewers probed into the engagement team's risk assessment processes. The reviewers also selected three or four key risk areas at the specific account or class of transactions level for in-depth evaluation. Those evaluations covered the assessment of inherent, control and fraud risks, and how those assessments were linked to the

³ Peer reviews are described in Appendix C.

substantive tests performed by the engagement team. The reviewers also assessed the design and performance of substantive tests. In addition to the key risk areas, they addressed the use of analytical procedures in five additional audit areas on each engagement. They also probed into how the audits were completed, including how engagement teams considered their audit findings and resolved issues. The QPR also evaluated how the auditors interacted and communicated with the entities' audit committees.⁴

Findings and Conclusions

2.14 The Panel is satisfied that the audit risk model is appropriate, but needs enhancing and updating. It embraces judgment in an organized and logical way. Input from the Panel's survey and other activities disclosed that the model is widely accepted, although some evidence suggested that the model is somewhat out-of-date and inconsistently implemented. Some participants suggested that the model is out-of-date for purely technical reasons, such as its failure to include the concept of engagement risk, its not clearly including fraud risk within the concepts of inherent risk or control risk, and because it does not adequately address the greater uncertainties resulting from increasingly complex transactions and events and the accounting for them. Others suggested that the model is not sufficiently specific and rigorous, does not call for a deep understanding of business processes and related risks, and thus cannot be applied consistently. Still others suggested that the model should drive more procedures directed at the detection of fraud. Some also believed that the concept of materiality in the model is too vague, both in how it is applied in planning audits and how it is used in evaluating audit results. Lastly, others believed that the model is linked too closely to audits of historical financial statements to accommodate an expanded notion of assurance services that contemplates providing assurance about many other kinds of information, in some cases on a continuous basis.

2.15 The Panel's recommendations to improve audit effectiveness are designed to enhance the audit risk model and promote its consistent application in financial statement audits. In the Panel's view, the recommendations do not call for a wholesale abandonment of the model, although some of them may be perceived as significantly modifying it. The recommendations are addressed to the constituencies that the Panel believes are in the best position to implement them. In the final analysis, however, the Panel recognizes that it is the conscientious performance of individual auditors that most contributes to audit effectiveness.

2.16 The Panel is confident that its recommendations will meet both the current needs of investors for assurances on financial statements and their needs for the foreseeable future. At the same time, the Panel recognizes that unprecedented changes are taking place in the global economy and capital markets, and that auditing standards and audit firms' methodologies will change as investors' needs for assurances on financial and non-financial information evolve. However, the Panel believes that many of its recommendations will enhance and update the audit risk model and provide a solid foundation for addressing the future needs of the marketplace.

⁴ The QPR was designed to provide a qualitative assessment of audit effectiveness; it was not designed to identify instances of non-compliance with specific standards or firm policies. Certain matters, resulting from QPR reviewers' disagreements with the quality or sufficiency of the work of an engagement team, were referred to the audit firm for appropriate follow-up.

2.17 Overall, the findings from the QPRs were favorable and did not support the view that audits are being conducted in an ineffective manner. Notwithstanding the generally positive QPR results and the Panel’s conclusions about the appropriateness of the audit risk model, the Panel believes that audits should be strengthened in a number of important ways. In its analysis of the quality of audits and how audits should be improved, three major themes emerged:

- First, definitive auditing standards form the starting point for promoting quality audits.
- Second, audit firms need comprehensive and vigorous audit methodologies, based on the standards, in order to drive the behavior of their auditors to a higher plane.
- Third, the peer review process is a critical element in “closing the loop” to provide assurance to the public that audit performance measures up to high standards and continues to improve.

From these three themes, the Panel created a framework for developing its recommendations.

A Framework for Developing Recommendations

2.18 The Panel’s framework for developing recommendations to improve the conduct of audits consisted of identifying the areas where the Panel believed improvements were desirable and specifying the key constituencies that are best able to carry out its recommendations.⁵ Those key constituencies are:

- the Auditing Standards Board
- the firms that audit the financial statements of public entities
- the SEC Practice Section of the AICPA

2.19 The ASB promulgates auditing standards and quality control standards that auditors and their firms are required to follow in their accounting and auditing practices. Those standards measure the quality of performance that auditors should adhere to in conducting their audits and that firms should follow in conducting their practices. The audit firms obtain the clients; hire, train, develop and provide career opportunities for their personnel; and develop audit methodologies and quality control systems to help ensure that audits are performed in accordance with professional standards. The SECPS establishes requirements for its members. The SECPS Peer Review Committee determines whether the firms follow the quality control standards in their accounting and auditing practices and the auditing standards in the conduct of their audits, and thus serves to “close the loop” between the standards and the way audits

⁵The Panel’s recommendations to improve the conduct of audits also include some that are addressed to constituencies that did not fall precisely in its framework. In certain areas, recommendations have been made to the SEC, the AICPA, the Public Oversight Board, the SECPS Quality Control Inquiry Committee, the Financial Accounting Standards Board and audit committees.

actually are performed. The activities of the SECPS are overseen by the Public Oversight Board (POB) to further ensure that the system functions as intended.

2.20 The recommendations to the various constituencies in the ensuing sections of this chapter and in Chapters 3 and 4 are based principally on the Panel’s QPR findings, together with knowledge gained from its survey (Appendix H), public hearings and comments on its Exposure Draft (Appendices I, N and O), focus groups and interviews (Appendix G), reviews of firms’ methodologies (Appendix J), research and analysis of cases of alleged audit failures (Appendix F) and other investigative and deliberative activities.

2.21 Thus, the Panel’s recommendations spring from a variety of sources. They are intended to foster wider use of “best practices” that the Panel has identified, as well as suggest improvements for perceived deficiencies.⁶ For example, some of the recommendations to the ASB call for enhancing professional standards to recognize practices that are widely, although not universally, applied. Similarly, some of the recommendations to audit firms are designed to bring the quality of all firms’ internal guidance up to a “best practices” level.

2.22 The Panel believes that each of its recommendations is individually important, but also that they need to be viewed in their totality. Recommendations addressed to only one constituency are less likely to lead to major changes in how audits are conducted; action by all constituencies is necessary to assure the public that the recommendations will achieve their objectives.

Auditing Standards Board

2.23 Many of the Panel’s recommendations to the ASB in specific areas suggest the need to examine existing auditing standards critically, with the objective of revising or replacing some or all of them with more specific and definitive guidance containing imperatives to guide auditors in formulating their judgments and carrying out their work. (Some of the recommendations to the ASB seek to make its quality control standards similarly more specific and definitive.) In so doing, the ASB should not pay blind homage to the current audit risk model when there are more useful or practical alternative approaches.

2.24 A call for standards that provide specific and definitive guidance is not a call for standards that diminish or remove the need for auditor judgment. Nor is it a call for standards that incorporate detailed checklists of auditing procedures. A good example of an existing standard that the Panel believes contains a specific and definitive imperative is found in the section of SAS No. 67, *The Confirmation Process*, titled “Confirmation of Accounts Receivable.”⁷ In fact, a number of the Panel’s recommendations call for auditors to make explicit judgments in areas where they may not always be doing so.

⁶ The QPR reviewers were instructed not to limit themselves to the engagement team’s compliance with the firm’s policies or professional standards, but also to indicate strong points and best practices observed in the areas reviewed. See Appendix E.

⁷ This aspect of SAS No. 67 is discussed in this chapter under “Linking the Risk Assessments to Substantive Tests,” under the caption “*Substantive Tests*.” In this case, the imperative is stated as a presumption that the auditor will request confirmation of accounts receivable.

2.25 By observing that the ASB need not adhere to the current audit risk model, the Panel implicitly recognizes the potential for changes to that model to promote audit effectiveness and meet the ever-changing needs of the auditing profession. The ASB should not feel constrained to follow a model that is inflexible and incapable of being adapted to meet emerging needs or new business conditions. For now, however, the Panel's evaluation of the audit risk model essentially supports its continuation, as enhanced and updated by the Panel's recommendations.

2.26 A major objective of auditing standards should be to help audits serve not only to detect material fraud but also, by being perceived as rigorous, to deter fraud from occurring in the first place. Toward that end, the Panel recommends that auditing standards require auditors to possess a far deeper understanding of the entity's business processes, risks and controls, and that substantive tests with the principal objective of detecting material financial statement fraud be designed and performed on all audits.

2.27 The Panel believes that the ASB, with its access to staff and volunteer resources with information technology expertise and its contacts with the academic community, could act as a catalyst for identifying how technology might facilitate and improve the audit process. Research efforts in partnership with audit firms and academia might lead to breakthrough ideas that could benefit the auditing profession. The Panel encourages the ASB to pursue this suggestion.

Audit Firms

2.28 Many of the Panel's recommendations in specific areas suggest that audit firms need to undertake substantive efforts to reestablish the importance of the role of independent auditors within their organizations and thereby reinvigorate their audit practices. They should provide guidance to their audit personnel that is specific and definitive and should focus more on training audit personnel in the methodologies that support their audit practices (including how to both use technology and audit their clients' use of it). Audit firms should embed intolerance for audit failures in their cultures. The concept of professional skepticism should be taught effectively and the role of auditors in the detection, and implicitly in the deterrence, of fraud reinforced.

2.29 Definitive professional standards and well-conceived firm policies, procedures, guidance materials, practice aids and audit training programs must be accompanied by a strong commitment by the audit firms to make continuous improvements in their processes and strive to meet the goal of "zero defects." The firms' leaders should convey a tone of high professionalism as the principal message to their auditors and should develop systems for incentives, compensatory rewards and penalties, and promotions that not only mirror the tone but also make it a reality.

SEC Practice Section of the AICPA

2.30 Many of the Panel's recommendations reflect a belief that the SECPS should be the source of both leadership and specific guidance to audit firms in the effort to strengthen their quality controls. Only with specific guidance can peer reviewers effectively assess compliance with quality control standards. The SECPS Peer Review Committee should make its peer

reviews of firms not only more frequent, but also more rigorous.⁸ The role of peer review in a program of continuous improvement of audit effectiveness should be given high priority. The SECPS's role in providing assurance that audits are being conducted effectively, with appropriate oversight by the POB, is critical to maintaining the profession's right to regulate itself.

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2.31 The remainder of this chapter and Chapter 3 discuss the Panel's findings from the QPR process. Generally, for each specific audit area, there is an overview of the requirements of GAAS, the significant findings from the QPR and how the Panel considered them, and the Panel's recommendations. Not all aspects of the audits that were reviewed in the QPR process or all the qualitative assessments made by the QPR reviewers are discussed in detail, although all of the findings were reviewed and considered by the Panel.

ASSESSING ENGAGEMENT RISK

2.32 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, notes that "in addition to audit risk, the auditor is also exposed to loss or injury to his or her professional practice from litigation, adverse publicity, or other events arising in connection with financial statements audited and reported on." This exposure, often referred to as "engagement risk," is not part of the audit risk model. It is present even though the auditor has performed the audit in accordance with GAAS and reported appropriately on the financial statements. Engagement risk usually is assessed as part of the audit firm's client acceptance and continuance procedures.

Requirements in Statements on Quality Control Standards (SQCS)

2.33 Client acceptance and continuance is one of the five elements of quality control identified in SQCS No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, issued by the Auditing Standards Board.⁹ The client acceptance and continuance process should be designed to provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized.

2.34 The process ordinarily is designed to enable the engagement team to identify and consider the risks associated with the overall engagement – such as the risk that the entity will fail, the risk that the entity's management lacks integrity, the risks inherent in the entity's industry, and the capabilities and track record of senior management – and then to use the resulting information to make an engagement risk assessment. The risks, individually and in the aggregate (or the absence of risks), also should affect the inherent, control and fraud risk

⁸ Panel recommendations to the SECPS Peer Review Committee also are made under "Enhancing Peer Reviews" in Chapter 6.

⁹ The ASB issues both SASs and SQCSs. Auditing standards relate to the conduct of individual audit engagements, while quality control standards relate to the conduct of a firm's audit practice as a whole. Firms that are members of the SECPS must adhere to the quality control standards as well as the SECPS membership requirements.

assessments discussed in subsequent sections of this and the following chapter, and in turn the nature, timing and extent of the auditor's tests.

2.35 The QPR examined the engagement risk assessment made during the client acceptance and continuance process and the specific actions, if any, taken to address the identified risks.

Findings

2.36 The QPR reviewers generally agreed that the engagement risk assessments (e.g., high, moderate or low) by the audit engagement teams were appropriate, that the thought processes applied in determining the engagement risk assessments and the specific actions to be taken were thorough and gave appropriate consideration to the appropriate factors, and that the right people, namely, partners, were involved in the process. The reviewers also generally agreed with the specific actions taken to address the specific risks identified; that the right people developed, reviewed and approved those actions; that they were completed effectively and in a timely manner by the right people; and that the working papers adequately documented the actions taken and the results.

2.37 All eight firms included in the QPR consider client acceptance and continuance, including the engagement risk assessment, to be a key element of their quality control system and risk management efforts. They all devote substantial attention to it at high levels within the firm. The firms have strengthened their policies and procedures in this area in recent years, and some have improved their processes by computerizing them. Computerization generally has enabled a firm to improve its abilities to identify the risks associated with potential and current clients and to monitor compliance with its policies more effectively. In addition, computerization has enabled high-level risk management personnel to be involved in client acceptance and continuance decisions on a more timely basis.

2.38 The Panel observed that some of these computerized systems are highly developed and involve both quantitative and qualitative factors, including a search for potentially derogatory or other information about the entity and its principal owners and officers. These systems require various levels of consultation and approvals depending on the particular circumstances, for example, the calculated "risk score," and they are monitored electronically to ensure that required procedures are completed in a timely manner. These systems also are integrated into the audit itself. Information regarding any significant risk factors that are identified and the action plans for dealing with them is included in the audit working papers and considered by the engagement team when planning and performing the audit.

Recommendations

To audit firms:

2.39 The Panel recommends that audit firms consider adopting sophisticated, computerized systems for identifying engagement risk that involve both quantitative and qualitative factors, including a search for potentially derogatory or other information about the entity and its

principal owners and officers, and integrating those systems into their audits.¹⁰ A cooperative effort by the firms to share best practices should facilitate implementing this recommendation.

ASSESSING INHERENT RISK

Overview of GAAS

2.40 SAS No. 47 defines inherent risk as “the susceptibility of an assertion to a material misstatement, assuming that there are no related controls.”¹¹ The risk of misstatement is greater for some assertions and related account balances and classes of transactions than for others. For example, complex calculations are more likely to be misstated than simple ones. Cash is more susceptible to theft than an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risk of error than do accounts consisting of relatively routine, factual data.

2.41 External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be reported at more than its net realizable value. In addition to factors that are unique to a specific assertion for an account balance or class of transactions, some factors may relate to various assertions for several or all of an entity’s account balances or classes of transactions. These latter factors are referred to in this report as overall inherent risk factors and include, for example, a lack of sufficient working capital to continue operations, a declining industry characterized by a large number of business failures, aggressive analysts’ forecasts and management compensation that is largely performance based.

2.42 SAS No. 47 notes that the auditor needs to have an understanding of inherent risk and an appropriate basis for assessing it below the maximum. The SAS does not specify the depth of knowledge necessary or require the auditor to perform any activities or procedures to assess inherent risk. Furthermore, it does not specify the depth of knowledge, activities or procedures necessary to assess inherent risk below the maximum, as in the case of control risk. Also, SAS No. 47 indicates that the auditor should assess inherent risk at the maximum when designing audit tests if he or she concludes that the effort required to assess inherent risk below the maximum for an assertion would exceed the potential reduction in audit procedures derived from such an assessment.

Findings

2.43 The QPR reviewers determined who performed and reviewed the inherent risk assessments both at the overall financial statement level and for each of the key areas selected. They also considered the appropriateness of the risk assessments and how they were made.

¹⁰ In Chapter 4, the Panel recommends that the AICPA develop, or promote the development of, a technology-driven tool that small firms can use to enhance the effectiveness of their client acceptance and continuance processes.

¹¹ The auditing literature defines an assertion as a representation by management that is embodied in a financial statement component. The five assertions are existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure.

2.44 The reviewers generally agreed with both the overall inherent risk assessment and the inherent risk assessments at the specific account or class of transactions level. They also agreed that, in general, the people involved in those assessments had the appropriate knowledge and skills, that they gave appropriate consideration to the various factors and that the right people reviewed the assessments at the right time. The assessments generally were made at an appropriate level (e.g., the assertion level for account balances and classes of transactions). While generally expressing their agreement, some reviewers nonetheless indicated a need for improvements in this area.

2.45 In recent years, the eight firms that participated in the Panel's QPR have made efforts to provide their audit personnel with significant industry and entity-specific information (often in the form of electronic databases). They also have been increasing their emphasis on how the auditor's understanding of the entity's business and industry can be enhanced, for example, by interviewing entity personnel outside of the accounting and finance functions. Many of the participants in the focus groups spoke enthusiastically about these developments. The Panel applauds these efforts and believes they should assist auditors in making better inherent risk assessments. The Panel also believes that all auditors would benefit from similar efforts.

2.46 Moreover, the Panel believes that the professional standards, guidance and practices with respect to assessing inherent risk need strengthening, given the increasing emphasis on inherent risk assessments in determining the nature, timing and extent of audit tests.¹² For example, SAS No. 47 currently permits the auditor to assess inherent risk with respect to a particular account or class of transactions as a whole, rather than requiring the auditor to make the risk assessment at the assertion (or lower) level by considering what could go wrong. The Panel believes that it is not sufficient merely to indicate that inherent risk with respect to revenue recognition, for example, is high or at the maximum. Rather, the auditor should be required to determine precisely why it is "high" (e.g., as a result of the complexity of sales terms, potential cutoff problems, "channel stuffing," understated deferred revenue, or side agreements permitting rights of return if the goods are not sold). The Panel believes that such a requirement would better prepare the auditor to select and perform the appropriate tests of controls and substantive tests.

2.47 Also, by assessing inherent risk at the maximum because it is more efficient to do so, the auditor may design substantive tests without fully understanding what could go wrong. In so doing, the auditor unintentionally may omit certain important audit tests and assume a higher level of detection risk than is intended or appropriate. Requiring a level of knowledge even for an assessment at the maximum, and specifying the types of activities or procedures necessary to assess inherent risk below the maximum, also could help prevent similar results.

¹² For example, the Panel noted during its study of SEC Accounting and Auditing Enforcement Releases (AAERs) (see Appendix F) several instances in which the entity's inherent risk apparently increased as a result of significant changes in its business (e.g., the loss of a major customer or the existence of a new competitor with a better, cheaper product) and the auditors apparently did not assess accurately how those changes increased inherent risk.

Recommendations

To the Auditing Standards Board:

2.48 The Panel recommends that the ASB:

- Require the auditor to make inherent risk assessments for significant account balances and classes of transactions by considering what could go wrong at the individual assertion level
- No longer permit the auditor to default to assessing inherent risk at the maximum for efficiency or other reasons without considering what could go wrong in specific financial statement assertions
- Provide additional guidance regarding the factors that affect inherent risk, including the entity's business processes and risks, and the depth of the auditor's understanding of those factors¹³
- Indicate the depth of auditor knowledge and the nature of activities or procedures (and provide some examples of such activities or procedures) that the auditor might perform to support assessing inherent risk (at both the financial statement and account or class of transactions levels) below the maximum

To audit firms:

2.49 The Panel recommends that audit firms:

- Review and ascertain whether they need to augment their policies and guidance on assessing inherent risk, for example, to cover the types of matters described in the recommendations to the ASB
- Require that a partner be actively involved in making inherent risk assessments at both the overall financial statement level and the assertion level for significant account balances and classes of transactions
- Require that the inherent risk assessments for high-risk clients be reviewed by the concurring partner or an industry expert before the related tests of controls and substantive tests are designed and performed

¹³ The Panel is aware that a Joint Working Group (JWG) made up of representatives from large accounting firms, auditing standard setters and academics submitted to the International Auditing Practices Committee (see Chapter 7), the Assurance Standards Board of the Canadian Institute of Chartered Accountants, the Auditing Practices Board of the United Kingdom and Ireland, and the ASB in May 2000 a paper containing recommendations arising from a study of recent developments in the audit methodologies of the largest accounting firms. The JWG suggests that a greater business risk orientation by auditors might benefit audit quality, and the ASB may wish to evaluate its suggestions.

- Review their training materials on assessing inherent risk and ascertain whether they need to be augmented, in terms of either the time devoted to the subject or the materials used, such as by “real-life” case studies on assessing inherent risk. The training should reinforce the need for every engagement team to take the necessary time to gain a thorough understanding of the entity’s business and industry and do a thorough job of assessing inherent risk, at both the overall financial statement level and the assertion level for significant account balances and classes of transactions.

To the SECPS Peer Review Committee:

2.50 The Panel recommends that the SECPS Peer Review Committee:

- Request that peer reviewers evaluate the adequacy and extent of implementation of firms’ methodologies, guidance and training materials relating to assessing inherent risk
- Include items in the peer review questionnaires that address the appropriateness of the inherent risk assessments made, whether they were made at the appropriate financial statement levels, who made and reviewed them, and whether they were made and reviewed on a timely basis
- Request that peer reviewers include their findings in this area in their reports to the SECPS Peer Review Committee

MULTI-LOCATION AUDITS

Overview of GAAS

2.51 SAS No. 47, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, requires that the auditor consider the extent to which audit procedures should be performed at selected locations or components of an entity with operations in multiple locations or with components. The auditor’s identification of the specific locations or components is an important outcome of the risk assessment process. Auditing standards provide examples of the inherent and control risk factors an auditor should consider when selecting the particular locations or components to visit, such as the materiality of the location, the effectiveness of the entity’s control environment, and the frequency, timing and scope of monitoring activities by the entity or others at the location. The decisions regarding which locations or components to visit and how much audit work to perform at each of them can be complex, especially in audits of large multi-national entities with numerous businesses in many countries. These decisions on the scope of work in an audit are integral elements in the application of the audit risk model.

2.52 The first standard of fieldwork requires that audit personnel be properly supervised. SQCS No. 2 requires firms to establish policies and procedures to provide reasonable assurance

that the work performed by engagement personnel meets applicable professional standards, regulatory requirements and the firm's standards of quality. This includes firm personnel who perform work at all locations, including foreign locations. Developing an appropriate structure for supervising personnel on large, multi-location engagements requires careful consideration by experienced personnel.

2.53 The SECPS *Standards for Performing and Reporting on Peer Reviews* (Peer Review Standards) require that peer reviews cover the supervision and control, in accordance with U.S. professional standards, of any work on segments performed by U.S. and foreign offices or by domestic or foreign affiliates or correspondents.¹⁴ The Peer Review Standards also specify certain matters regarding work performed at other locations that should be documented in the working papers of the auditors in charge of the overall engagement. Such matters include the independence of the auditors at the other locations; how the auditors in charge of the overall engagement obtained reasonable assurance that the auditors at the non-U.S. locations are familiar with GAAS, GAAP and SEC regulations; and the procedures performed and conclusions reached when the auditors in charge of the overall engagement visited other locations.

Findings

2.54 The QPR reviewers were directed to address certain matters when the engagement involved an entity with significant facilities or operations that either were not audited or were audited by individuals who were not under the direct supervision of the engagement team whose work was being reviewed. The reviewers probed into the audit procedures, if any, performed at each location and the supervision and control that the auditors in charge of the overall engagement exercised over the work performed at other locations.

2.55 With one exception, which was addressed appropriately by the firm involved, the QPR reviewers agreed with the engagement teams' determination of the audit procedures to be performed for each location and the scope of those procedures. The reviewers also agreed that: the people involved in determining the audit procedures, if any, for each location had the appropriate knowledge and skills; the engagement partners were involved in a substantive, timely manner in the decision-making processes; and the engagement teams' supervision and control of the work performed at the various locations were adequate to provide reasonable assurance that the audits complied with GAAS (including complying with GAAS in audits conducted outside of the United States).

2.56 The Panel noted that there is little specific guidance in the professional literature on the appropriate audit coverage in a multi-location audit. The Panel believes there should be additional guidance in view of the increasing growth and globalization of many entities.¹⁵ The

¹⁴ The Peer Review Standards are issued by the SECPS Peer Review Committee and provide guidance on performing and reporting on peer reviews that are intended to meet the SECPS membership requirements.

¹⁵ The Panel noted during its study of AAERs (see Appendix F) several instances of material fraud, sometimes fraudulent financial reporting and other times misappropriation of assets, at relatively small divisions or subsidiaries. In some of these instances, the auditors apparently had not visited the locations in several years even though the entities did not have any internal auditors, controls at the locations were weak or competition for the locations' products had increased substantially.

Panel also noted that some firms have extensive guidance in this area that the ASB might find helpful in developing similar assistance.

Recommendations

To the Auditing Standards Board:

2.57 The Panel recommends that the ASB:

- Develop more specific and definitive standards for multi-location audits to cover such matters as:
 - How the auditor's consideration of the control environment (taken alone or in combination with other factors) should influence the selection of locations to be covered or the way procedures are to be carried out
 - The extent of knowledge and involvement needed by the auditor with final responsibility for decisions about the locations and the key personnel assigned to perform the work at them
 - Criteria (including materiality considerations) for periodically rotating the coverage of smaller locations
 - Reliance on internal auditors for coverage of various locations
 - Methods of establishing materiality at different locations
 - The scope of work to be performed at different sizes and types of locations
- Emphasize in its guidance that accounting systems, controls, personnel and other circumstances can vary widely from location to location within an entity, and that these variations should be considered explicitly in decisions about how many and which locations to visit and the nature, timing and extent of work to be performed at each of them. The guidance also should recognize that analytical procedures may be useful in helping to select the locations to be visited, especially when there are many rather homogeneous locations.

ASSESSING CONTROL RISK

Overview of GAAS

2.58 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement*

Audit: An Amendment to SAS No. 55, describes the auditor's responsibilities with respect to an entity's internal control, including the responsibility to assess control risk.

2.59 SAS No. 78 defines internal control as “a process – effected by an entity's board of directors, management, and other personnel – designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.”¹⁶ Controls that are relevant to an audit are those that pertain to the entity's preparation of financial statements for external purposes.

2.60 Internal control consists of five interrelated components:¹⁷

- The *control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
- *Risk assessment* is the entity's identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed.
- *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- *Information and communication* are the identification, capture and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- *Monitoring* is the process that assesses the quality of internal control performance over time.

2.61 GAAS require, in all audits, that the auditor “obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and whether they have been placed in operation.” This knowledge is used to:

- Identify types of potential financial statement misstatements
- Consider factors that affect the risk of material misstatement
- Design substantive tests

2.62 The risk that a material misstatement will not be prevented or detected on a timely basis by the entity's internal control is referred to as *control risk*. Some control risk always exists

¹⁶ The definition is the same as that adopted by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework*, September 1992.

¹⁷ Safeguarding of assets is an integral part of each of the components.

because of the inherent limitations of internal control and the possibility of control override by supervisory personnel.

2.63 Obtaining an understanding of internal control does not require the auditor to reach any conclusions about the effectiveness of internal control. GAAS allow the auditor to assess control risk as very high or at the maximum level in specific areas of the financial statements if he or she believes that controls are unlikely to be effective, or that evaluating and testing their effectiveness would be inefficient. This process is commonly expressed as “defaulting” to an audit approach that relies entirely on detailed substantive audit tests with little or no testing of controls.

2.64 GAAS further provide that the auditor may assess control risk at a lower level, below the maximum, by:

- Identifying specific controls that are likely to prevent or detect material misstatements relative to specific aspects of the financial statements
- Performing tests of those controls to evaluate their effectiveness

2.65 Assessing control risk below the maximum enables the auditor to adjust the nature, timing and extent of substantive audit tests, for example, by performing fewer tests, obtaining less persuasive (and presumably less costly) evidence, performing tests before year end or reducing sample sizes. When auditors “rely” on controls in an area, it means they have assessed control risk below the maximum level and have tested the effectiveness of those controls.

Findings

2.66 The QPR reviewers looked at auditors’ work in assessing control risk at the control environment level and in the key areas reviewed on each engagement, and at how the risk assessment was documented.

Control Environment

2.67 In all engagements, the auditors assessed the entity’s control environment. The work in this area generally was performed by an in-charge auditor with three to five years’ experience, working under timely and effective supervision and review by more experienced professionals. In substantially all situations, the QPR reviewer agreed with the engagement team’s assessment of the control environment.

2.68 The results indicated, however, that on nearly 17% of the reviewed engagements the audit would have been improved by more thoughtful analysis and in-depth auditor knowledge of the entity’s control environment. In addition, the QPR reviewers believed that, on about 21% of the engagements, more effective use of the audit firm’s information technology specialists would have been desirable and would have improved the team’s assessment of the control environment.

Assessing Control Risk and Testing Controls

2.69 The QPR reviewers found that the depth of understanding about information systems and controls, the substance of the risk assessments performed and the degree of reliance on controls varied considerably among engagements, even within the same firm. The process of obtaining an understanding of internal control typically consisted of some combination of completing checklists, interviewing entity personnel and examining individual transactions. On almost 24% of the reviewed engagements, the reviewers raised questions about the engagement team's thought process or depth of knowledge and understanding of the information system and related controls, including consideration of the entity's computer environment and processing.

2.70 The reviewers noted that firms' information technology specialists frequently were used by engagement teams to assist in understanding general computer controls or specific application controls in more complex computer-based systems. In some cases, these specialists also were used in the design and execution of related audit testing. The reviewers also observed, however, that the level and effectiveness of the coordination between the technology specialists and audit personnel varied, and in almost 20% of the engagements could have been improved. In addition, the reviewers frequently noted that an increased understanding of computer-based systems by engagement teams and the involvement of information technology specialists would have improved the control risk assessment process.

2.71 Assessing control risk below the maximum level and relying on controls to reduce detailed substantive audit tests were found to be somewhat uncommon, particularly for small and medium-sized entities. Testing and relying on specific application controls were more common on larger engagements. In high-risk key areas, controls usually were not relied on in lieu of detailed tests. The reviewers noted no situations in which they considered the planned reliance on internal control to be inappropriate.

2.72 When the auditor planned to rely on controls, however, the nature, timing and extent of tests of controls varied considerably. In some cases, there appeared to be some confusion about what constitutes an internal control over an identified risk versus simply a procedure for processing a transaction. Identification of controls relevant to the auditor's selection of substantive tests, and the corollary nature, timing and extent of controls testing that was appropriate in the circumstances, also seemed to be somewhat unclear to some engagement teams. In addition, the QPR reviewers concluded that the tests of controls were not completely effective in about 12% of the key areas reviewed where controls were tested.

2.73 The QPR reviewers often commented about the circumstances permitting rotation of tests of controls over two or more years, the circumstances in which tests of controls also may serve as substantive tests (referred to as "dual purpose tests"), and the necessary level of testing of management reports and other internal data sources used by the auditor in performing analytical procedures or other audit tests. The reviewers generally concurred with the concept of rotation, but sometimes questioned the appropriateness of the time lag between testing of specific areas or whether changes in the entity or the engagement team called for updated testing. The reviewers generally expressed reservations about whether the dual purpose tests were adequate as substantive tests to enable the auditors to achieve the desired audit objectives. Their comments

on the level of testing of management reports and other internal data sources that were used in performing analytical procedures or other audit tests indicated inconsistencies in practice.

Documentation

2.74 Engagement teams' documentation of their understanding and assessment of internal control takes different forms, including firm-specific checklists and preparation of detailed descriptions of the entities' policies and procedures. The QPR disclosed that documentation of the control environment was viewed as needing improvement on 15% of the engagements reviewed. The documentation of control work in the key areas was similarly lacking in substance or completeness on nearly 23% of the engagements and 14% of the key areas reviewed.

* * * * *

2.75 The findings are consistent with a widely held perception that auditors tend to focus on substantive tests rather than relying on and testing controls. The findings also are consistent with views expressed by both QPR engagement team members and focus group participants, which can be summarized as follows:

- Professional standards in this area are perceived by many as complex and difficult to apply, particularly with respect to the guidance on how much knowledge auditors need about internal control, the need to test controls and the nature and extent of controls testing.
- Professionals have a wide range of beliefs about the relevance of internal control and how internal control is, or should be, considered in audits. In addition, the level of knowledge about internal control, including understanding the types of errors that can result from internal control weaknesses, and how internal control fits or should fit into the audit process, varies widely among auditors.¹⁸
- Testing controls is considered time consuming and seems to be viewed by some auditors, including partners, as less effective than detailed substantive audit tests. There is confusion about when, if ever, an auditor can rely entirely on substantive tests for assurance about a particular assertion.
- There is a diversity of views about the most effective way of coordinating the work of information technology specialists with that of auditors and the role of those specialists in understanding, assessing and testing controls. The ability of engagement personnel to supervise the work of these specialists is often questioned.

¹⁸ During its study of the AAERs (see Appendix F), the Panel noted numerous instances of management overriding controls unbeknown to the auditors. These included controls over the aging of accounts receivable, recording shipments, changing computer programs and classifying payments. As a consequence, the auditors assessed control risk and fraud risk as being lower than they actually were. The Panel also noted that entities often used information technology to facilitate material fraud, such as by making inappropriate modifications to computer programs, making large numbers of small non-standard entries rather than a few large ones, and "freezing the date" in the computer system.

2.76 In contrast, the Panel is aware that some auditors and firms believe that increasingly there is little choice but to focus the audit more on controls, given the pervasiveness of complex computer systems and the volume of transactions. To do otherwise, they argue, is not responsive to the need for highly reliable interim, as well as year end, financial data and increasingly will result in highly inefficient, costly and often ineffective audits. Firm methodologies seem to be focusing more on controls in planning the audit.

Recommendations

To the Auditing Standards Board:

2.77 The Panel recommends that the ASB:

- Provide more specific guidance on:
 - The required depth of auditor knowledge and understanding about internal control
 - Whether and to what extent auditors may rely on their assessments of the effectiveness of the control environment (including corporate governance) and management's high-level monitoring of the business to support control risk assessments below the maximum¹⁹
 - The nature and extent of documentation needed, particularly to support the auditor's consideration of internal control in planning the audit and in assessing control risk
 - The circumstances, if any, in which auditors may rely entirely on detailed audit tests with either no reliance on controls or reliance only at the control environment level
 - Identifying and focusing on key controls for the purpose of determining what could go wrong and what controls to test
 - Linking the "components of internal control," including transaction-level controls, with identified risks and detailed audit tests
 - The nature, timing and extent of controls testing in varying circumstances
 - The circumstances, if any, permitting rotating tests of controls over two or more years in areas in which the auditor intends to rely on controls

¹⁹ The JWG paper (see note 13) contains observations about these matters that the ASB may wish to evaluate.

- The circumstances, if any, in which tests of controls also may constitute substantive tests (dual purpose tests)
- The necessary level of testing of management reports and other internal data sources used by the auditor in performing analytical procedures or other audit tests
- Indicate the importance of having personnel with significant audit and industry experience participate in performing internal control work, particularly at the planning stage
- Give priority to completing the work of the ASB technology task force that was formed to consider the manner in which auditing standards taken as a whole appropriately reflect the use and impact of information technology and whether changes should be made to auditing standards

To audit firms:

2.78 The Panel recommends that audit firms place a high priority on enhancing the overall effectiveness of auditors' work on internal control, particularly with respect to the depth and substance of their knowledge about companies' information systems. The following areas should be addressed:

- *Audit practice* – Firms of all sizes should examine critically their audit work on internal control. In many situations, firms should increase the engagement time allotted to internal control, particularly in the audit planning phase. They also should raise the level of involvement by more experienced audit personnel. Audit personnel who supervise engagements should be directed to focus on increasing the engagement team's knowledge of important information systems and controls. They should focus particularly on (1) obtaining a more thorough understanding of information systems relevant to financial reporting and the related risks and controls, (2) identifying and evaluating the design of key controls, (3) linking controls with identified risks and substantive audit tests, (4) designing tests of the operating effectiveness of controls, (5) considering the results of the tests of controls, and (6) considering how decisions about the nature, timing and extent of controls testing affected audit effectiveness.
- *Professional development* – Training programs should place greater emphasis on each of the components of internal control as well as on assessing and testing controls. The objective should be to increase significantly the overall effectiveness of auditors in identifying and responding to risks, key controls and control deficiencies in the control environment and information systems.
- *Information technology* – The Panel sees an increasing need for auditors to have a higher level of technology skills and for more effective participation in audits by information technology specialists. Their participation should include assessing the

risk that erroneous information may affect the financial statements, assessing the adequacy of controls and designing tests of their operating effectiveness. Firms should develop specific training materials and programs to make auditors more knowledgeable about information technology, and information technology specialists more knowledgeable about auditing. Information technology specialists should be integrated more effectively and consistently into the audit process. There should be joint training of auditors and specialists, starting at the partner and manager levels. Firms without such specialized capabilities should develop appropriate cooperative arrangements to ensure that information technology risks and controls are fully addressed in the audit.

- *Inspection programs* – Internal inspection programs should increase their focus on internal control work, the effective involvement of information technology specialists and the effective involvement of experienced audit personnel in this area.

To the SECPS Peer Review Committee:

2.79 The Panel recommends that the SECPS Peer Review Committee:

- Develop more detailed inquiries for peer reviewers about firms' methodologies and engagement performance relating to audit work on internal control, focusing particularly on internal control considerations in planning the audit. Peer review inquiries also should focus on the depth of the engagement team's understanding of the entity's information system and related risks that are relevant to financial reporting. In addition, they should address the engagement team's effectiveness in identifying, testing and assessing key controls, and the sufficiency of the involvement of experienced professionals.
- Instruct peer review team captains to include professionals with the necessary specialized technology expertise on their peer review teams
- Request that peer reviewers include their findings in this area in their reports to the SECPS Peer Review Committee

COMMUNICATING AND REPORTING ON INTERNAL CONTROL

Overview of GAAS

2.80 The auditor's standard report on a financial statement audit does not address internal control or purport to give any assurance about it, and auditors are not required to assess the overall effectiveness of internal control or search for control deficiencies. During the course of an audit, however, the auditor may become aware of matters relating to internal control that may be of interest to management or the audit committee (or equivalent body). SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, requires that auditors

communicate such matters if they meet the definition of a *reportable condition* – a significant deficiency in the design or operation of internal control that could adversely affect the entity’s ability to record, process, summarize, and report financial data consistent with management’s assertions in the financial statements.

2.81 A reportable condition may be of such magnitude to be considered a *material weakness*. A material weakness is defined as “a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.”

2.82 An auditor may be engaged to report on the effectiveness of internal control over financial reporting under the attestation standards (such standards are similar in concept to auditing standards and also are issued by the ASB). Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity’s Internal Control Over Financial Reporting* (as amended), prescribes performance and reporting standards for engagements to examine management’s assertion on the effectiveness of internal control over financial reporting. The Panel understands that SSAE No. 2 engagements and reports are rare outside of the banking industry. While there are statutory requirements for auditors to report on internal control over financial reporting in all larger banking institutions, the attestation reports on those engagements are provided only to the regulators and the audited entity. In addition, they are available to the public upon request.

2.83 Mandatory management and auditor reporting on the effectiveness of internal control for public entities has been considered in the past and continues to be advocated in some quarters. The 1987 *Report of the National Commission on Fraudulent Financial Reporting* (the Treadway Commission) specifically recommended that the SEC require management reporting to shareholders on the effectiveness of internal control. Similarly, in a 1993 report, *In the Public Interest*, the POB recommended that the SEC require management and auditor reporting on the effectiveness of internal control. The 1996 GAO *Report on the Accounting Profession – Major Issues: Progress and Concerns* contains an extensive discussion about the importance of internal control and states:

While the accounting profession now supports internal control reporting, the SEC has not been convinced of the merits of reporting on internal control. SEC support is critical to further progress in this area. In the long run, GAO expects that audits will be expanded to include internal control reporting, either because of market demand or some systemic crisis.

Findings

2.84 The QPR disclosed only a few instances of auditors specifically communicating “reportable conditions” or “material weaknesses.” This may result from (a) a lack of such conditions on the engagements reviewed, (b) the limited amount of internal control work performed by the auditors, (c) the subjectivity of the criteria for identifying reportable conditions

and material weaknesses, or (d) a combination of the above. The QPR results indicate that it is very common for auditors to report that the audit did not identify any "material weaknesses."

2.85 The Panel believes, based on focus groups and comments from QPR reviewers, that management and auditor communications with audit committees frequently do not devote sufficient time and attention to internal control. Audit committees likely presume that auditors do more work in this area than they actually do, and they take more comfort than is warranted or intended by the auditors. Audit committees seldom ask management and the auditors in-depth questions about internal control.

2.86 The Panel recognizes that many public companies include statements by management in their annual reports acknowledging management's responsibility for the system of internal control. Some of these management reports – typically found among the larger public companies – express management's views about the effectiveness of the system and, in some cases, the basis for its views. Management reports generally include references to the auditors, and some may lead users to incorrect inferences about the auditors' work on controls in the context of a GAAS audit, particularly since companies seldom engage their auditors to report on such management reports. (The QPR did not address attestation engagements to report on the effectiveness of internal control over financial reporting.)

2.87 It is widely recognized that effective internal control is critical to the reliability of the financial reporting process. The use of information technology, the growing complexity of systems and processes, the sheer volume of transactions, the global reach of business entities and other factors were cited as evidence of this by many of those responding to the Panel's requests for input. It also is clear from discussions with focus group participants, firm leadership and others that there has been and continues to be a significant gap between what management, audit committees and investors believe auditors' involvement with internal control is or should be, and reality. Input to the Panel on the need for management reporting on the effectiveness of internal control, and auditor involvement and reporting thereon, was mixed. A number of survey respondents addressed this issue, with some constituencies supporting both management reporting and auditor involvement and reporting thereon, while others opposed auditor involvement and reporting. After considering all these views, the Panel concluded that, while it would not make a recommendation to the SEC that it require management and auditors to report on internal control, it would emphasize the need for greater audit committee involvement with internal control matters. The Panel also recognizes that, as the demand for new and timelier information rises, management and auditor reporting on controls may become inevitable.²⁰

Recommendations

To audit committees:

2.88 The Panel recommends that audit committees increase the time and attention they devote to discussions of internal control with management and both the internal and external auditors. Specifically, audit committees should:

²⁰ See "The Information Demand" in Chapter 8.

- Obtain a written report from management on the effectiveness of internal control over financial reporting (ordinarily using the criteria in the 1992 report of the Committee of Sponsoring Organizations of the Treadway Commission [COSO]).²¹ Annual reporting by management on internal control to the audit committee is necessary for the effective discharge of the audit committee’s responsibilities and will serve as a catalyst for its more substantive involvement in the area of internal control and a more meaningful dialogue with the internal and external auditors about controls. It also should provide a basis for discussions about the degree of the external auditor’s involvement with internal control during the financial statement audit.
- Establish specific expectations with management and the internal and external auditors about the qualitative information needs of the committee related to internal control. Particular emphasis should be given to understanding management’s and the auditors’ views on (1) the control environment and (2) the controls (or lack thereof) over financial reporting, with particular attention to controls in higher-risk areas of the company’s information systems. In addition, these discussions should include the effects of technology on current and future information systems.

To the Securities and Exchange Commission:

2.89 The Panel recommends that, if management is required to report to shareholders on the effectiveness of internal control, the SEC require either external auditor reporting on internal control or management to explicitly state that the external auditors do not express an opinion on internal control. Otherwise, the Panel believes that investors may draw unwarranted inferences about auditors’ involvement with and responsibility for the appropriateness of management’s assertions in such reports or about the degree of internal control work that auditors perform in connection with their audits of financial statements.

LINKING THE RISK ASSESSMENTS TO SUBSTANTIVE TESTS

Overview of GAAS

2.90 The major reason for the auditor’s risk assessment activities is to provide a basis for determining the nature, timing and extent of substantive tests to be performed to provide the reasonable assurance the auditor needs about the reliability of the assertions that are embedded in the financial statements. This determination often is referred to as “linkage”; it is one of the most difficult and important sets of decisions that the auditor must make, requiring considerable judgment, and should be made and reviewed by experienced personnel with the appropriate level of knowledge and skills.

2.91 All other things being equal, the higher the risks, the more the auditor should focus on the nature of the substantive tests, the more extensive the substantive tests need to be, the more

²¹ See note 16. Such reports also may be provided jointly with the internal auditors.

persuasive the evidence they provide should be, and the nearer to the balance sheet date they should be performed. (SAS No. 39, *Audit Sampling*, provides additional guidance on linking risk assessments to sample sizes in situations in which sampling is appropriate.) While the auditor is permitted to exercise considerable judgment in the linkage process, SAS No. 47 cautions that it is not appropriate to rely completely on the risk assessments to the exclusion of performing substantive tests of material account balances and classes of transactions. The auditor also should consider the various risk assessments in assigning staff and determining the appropriate level of supervision.

Findings

2.92 The QPR reviewers evaluated the engagement team’s linkage decisions for the key areas on each engagement reviewed. The reviewers also considered the appropriateness of the substantive tests performed, the timing of the tests, whether the number of items included in a particular test or sample was adequate, the adequacy of the documentation, whether the appropriate personnel performed and reviewed the work, whether any “exceptions” were resolved appropriately and whether the responses of entity management to the auditors’ inquiries were adequately corroborated. At the conclusion of both the review of each key area and the overall engagement, the reviewers evaluated whether all major issues that arose in the key area or on the engagement, respectively, were resolved appropriately and whether consultation had occurred when it should have and, if so, the appropriateness of the consultation process.

Linkage

2.93 The QPR reviewers generally agreed that the specific tests performed or other actions taken in response to each of the risk assessments were appropriate and sufficient and that they clearly addressed the specific potential misstatements that the engagement team identified. The reviewers also generally agreed that the thinking that led to the specific tests or actions gave appropriate consideration to the appropriate factors, that those who initially selected the specific procedures had the appropriate knowledge and skills to perform those tasks, and that those who reviewed and approved them also had the appropriate knowledge and skills and did so on a timely basis. Although the reviewers generally agreed that the number of items examined in particular substantive tests was adequate in light of the risk assessments, they noted significant differences in sample sizes – sometimes in reasonably similar circumstances, even within the same firm. Even though the reviewers generally agreed with the linkage decisions, they believed the linkage needed improvement in 7% of the key areas reviewed.

Substantive Tests

2.94 In approximately 10% of the key areas reviewed, the QPR reviewers did not agree that the substantive tests (nature, timing and extent) appropriately addressed the relevant assertions to achieve the necessary level of audit assurance. In addition, in approximately 15% of the key areas reviewed, the reviewers did not agree that the documentation of the substantive tests and their results was appropriate (e.g., that there was sufficient information in the working papers to enable someone else to replicate the original work and understand the nature of the evidence examined).

2.95 The QPR reviewers generally agreed that the engagement teams clearly understood the entity's policies and processes related to the key areas reviewed and that the people who performed the tests, including specialists when appropriate, had the necessary knowledge and skills.

2.96 The reviewers also generally were satisfied that the engagement teams performed appropriate procedures to understand and evaluate the work performed by specialists, that sufficient tests were performed for the period between interim and year end when interim testing was performed, and that sufficient substantive tests were performed. The reviewers generally agreed that key entity documents (e.g., contracts) and the results of the substantive tests were reviewed on a timely basis by an engagement team member with appropriate knowledge and skills, that exceptions found in testing were resolved appropriately and that decisions about the need for additional substantive tests were appropriate.

2.97 The QPR reviewers noticed a tendency in some instances for engagement teams not to confirm material receivables even though SAS No. 67, *The Confirmation Process*, states that:

Confirmation of accounts receivable is a generally accepted auditing procedure. ... [I]t is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity. Thus, there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless one of the following is true:

- Accounts receivable are immaterial to the financial statements.
- The use of confirmations would be ineffective. For example, if based on prior years' audit experience or on experience with similar engagements, the auditor concludes that response rates to properly designed confirmation requests will be inadequate, or if responses are known or expected to be unreliable, the auditor may determine that the use of confirmations would be ineffective.
- The auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

2.98 When questioned, the engagement teams generally responded that they had not attempted to confirm receivables, even though they were material, on the basis that the second or third condition was met. In some instances, it was clear that one or both of the conditions were met;

however, in other instances, it was not apparent that either condition was met. The Panel is aware from the focus groups and other input that some auditors believe that confirmation is not a particularly effective audit procedure in many situations.

2.99 On a few engagements, the QPR reviewers noted that the engagement team permitted the entity's personnel (other than internal auditors) to mail or receive the confirmation requests or the auditors accepted facsimile responses without taking appropriate precautions, such as verifying the source and contents of the response by a telephone call to the purported sender. (SAS No. 67 requires the auditor to maintain control over the confirmation requests and responses and to consider taking certain precautions to verify the propriety of any facsimile responses.) These conditions also were present in some of the cases the Panel studied in its review of litigation or enforcement actions against auditors.²²

2.100 In approximately 8% of the key areas where the engagement teams noted confirmation exceptions, the QPR reviewers found that the exceptions were resolved inappropriately and that the decisions regarding the need for additional substantive tests were inappropriate. This condition also was present in some of the cases the Panel studied in its review of litigation and enforcement actions against auditors.

Resolution of Issues

2.101 The QPR reviewers generally agreed that the engagement issues raised in the key areas were resolved appropriately, that the engagement teams performed appropriate tests to obtain reasonable assurance that they had all of the relevant information pertaining to those issues, and that, if necessary, there was appropriate consultation.

2.102 In 14% of the situations, the QPR reviewers found that the documentation concerning the issues in the key areas and their resolution was inappropriate. When the reviewers were able to conclude that the resolution of those issues was appropriate, they ordinarily did so on the basis of discussions with members of the engagement team and, when applicable, with those consulted by the engagement team.

2.103 The reviewers also generally agreed, on an overall basis when completing their review of the audit, that the engagement team carefully reviewed and objectively evaluated, in light of all of the circumstances, all of the issues identified during the course of the audit. The reviewers also generally found that the people involved with the issues and their resolution had the appropriate knowledge and skills, and that the audit partner was involved sufficiently and on a timely basis in their consideration and resolution.

2.104 The reviewers also generally concluded that there was appropriate and timely consultation about the key issues with the right persons at the right time, that all the relevant

²² The Panel noted during its study of AAERs (see Appendix F) numerous other instances in which the auditors' substantive procedures apparently were inadequate to detect material misstatements. Examples were: (a) not adequately following up on exceptions found through testing, (b) not adequately testing cutoff, charges to asset accounts, or the valuation of securities or property, plant and equipment, and (c) not ascertaining whether the financial statements agreed or reconciled with the accounting records.

information was provided to those consulted and that the nature, timing and extent of the concurring partner's involvement in the resolution of the issues were appropriate. Finally, the reviewers generally agreed that the conclusions reached with respect to each of the issues were appropriate, that the issues were identified and resolved on a timely basis (e.g., not late in the audit), and that there were sufficient discussions with management regarding the identified issues.

2.105 The QPR reviewers on 13% of the engagements indicated that they became aware of other issues about which they believed consultation with others in the firm would have been prudent or was required by firm policy, but did not take place.

Recommendations

To the Auditing Standards Board:

2.106 The Panel recommends that the ASB:

Linkage

- Develop more definitive authoritative guidance on linking the nature, timing and extent of substantive tests to risk assessments, including guidance aimed at the nature of procedures and at reducing the incidence of inadequate sample sizes and variations in sample sizes in similar circumstances. (The ASB, when developing that guidance, may wish to consider the non-authoritative AICPA Auditing Practice Release, *Audit Sampling*, published in 1999.)

Substantive Tests

- Articulate more precisely the considerations that should be present to overcome the presumption that it is necessary to send confirmations
- Undertake research to develop more effective methods of confirmation or other means of obtaining evidence from third parties, such as through the use of technology

To audit firms:

2.107 The Panel recommends that audit firms:

Linkage

- Review their policies and procedures and guidance materials with respect to linking risk assessments to the nature, timing and extent of substantive tests, including designing substantive procedures that address all assertions where risk is not low, and establishing sample sizes that are large enough to provide sufficient evidence whenever sampling (as defined in SAS No. 39) is employed

- Review their training materials with respect to linkage and sampling and ascertain whether they need to be augmented, with respect to either the time devoted to the subjects or the materials used, such as by developing “real-life” case studies

Substantive Tests

- Emphasize to their personnel the importance of obtaining evidence from third parties whenever possible and that the presumption that receivables are to be confirmed when they are material is not easily overcome
- Provide more guidance to their personnel on other types of information, in addition to or in lieu of receivable balances, that might be confirmed
- Develop case studies or other communications to audit personnel that illustrate the dangers of losing control over the confirmation process, of accepting facsimile responses to confirmation requests without taking appropriate precautions, and of not following up and appropriately resolving all exceptions noted during the audit
- Require that at least an experienced audit manager review the resolution of all “exceptions” noted during the audit and be satisfied that they were resolved appropriately and that appropriate decisions regarding the need for additional substantive tests were made

Resolution of Issues

- Reinforce the importance of consulting on important issues
- Vigorously enforce their consultation policies by taking strong actions with respect to those who do not consult when they should, as revealed by the firm’s inspection program or other events

To the SECPS Peer Review Committee:

2.108 The Panel recommends that the SECPS Peer Review Committee:

Linkage

- Request that peer reviewers evaluate the adequacy of firms’ policies, procedures, guidance and training materials relating to linkage decisions, including those involving the selection of the appropriate procedures and sampling
- Request that peer reviewers determine whether firms have conducted the requisite training in these areas and evaluate the effectiveness of the engagement teams’ implementation of the firms’ methodology and guidance materials

- Include items in the peer review questionnaires that are similar to those covered in the QPRs, such as whether the specific tests performed or other actions taken in response to the risk assessments were appropriate and sufficient, whether the thought processes that led to the specific tests or actions were thorough and gave appropriate consideration to the appropriate factors, whether those who initially selected and subsequently reviewed the specific tests or other actions had the appropriate knowledge and skills and did so on a timely basis, and whether the extent of substantive tests (including, when appropriate, sample sizes) was sufficient

Substantive Tests

- Request that peer reviewers evaluate whether engagement teams are (a) confirming receivables whenever they are material unless the presumption that receivables will be confirmed clearly has been overcome, (b) confirming other types of information in addition to, or in lieu of, receivable balances, when appropriate, (c) maintaining control over the confirmation process, (d) taking appropriate precautions when facsimile responses to confirmations are received, and (e) appropriately following up and resolving any exceptions noted and, when appropriate, performing additional audit tests

Resolution of Issues

- Request that peer reviewers consider whether there were any issues on the audit engagements reviewed for which they believed consultation would have been prudent (or was required by firm policy) and for which it did not occur (or was not documented)

Reporting

- Request that peer reviewers include their findings in these areas in their reports to the SECPS Peer Review Committee

ANALYTICAL PROCEDURES

Overview of GAAS

2.109 Analytical procedures are defined by SAS No. 56, *Analytical Procedures*, as “evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. . . . A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.” SAS No. 56 requires that analytical procedures be used in audit planning and in the overall review stage of the audit. Analytical procedures also may be used as substantive tests to identify potential material misstatements.

2.110 Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. SAS No. 56 notes that “the expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (a) the nature of the assertion, (b) the plausibility and predictability of the relationship, (c) the availability and reliability of the data used to develop the expectation, and (d) the precision of the expectation.

2.111 Analytical procedures by nature tend to elicit inquiries to management as auditors search for explanations when investigating significant unexpected differences or the absence of expected differences. SAS No. 56 admonishes, however, that “management responses ... should ordinarily be corroborated with other evidential matter.”

Findings

2.112 The QPR was designed to address all aspects of the use of analytical procedures in audits. Analytical procedures used in planning were addressed in the QPR’s probe into the risk assessments made by engagement teams, and analytical procedures used in the overall review stage of audits were examined in the QPR’s probe into the resolution of audit issues. In the key areas for each audit engagement, the QPR reviewers made direct inquiries concerning the effectiveness of analytical procedures used as substantive tests. Lastly, in five additional audit areas for each audit engagement, the reviewers addressed the effectiveness of analytical procedures when used as the primary or sole substantive test for the particular area.

Analytical Procedures in Audit Planning

2.113 For audit planning purposes, analytical procedures are employed as a tool to help the auditor understand the entity’s business and to identify areas that may represent specific risks relevant to the audit. Since most audits are planned before the end of an entity’s fiscal year, it is understandable that the expectations developed at the planning stage often are not made with a high degree of precision and the analytical procedures based on them are not intended to provide a high level of assurance. Analytical procedures in planning are one of a number of important elements, however, in the risk assessment process and in designing the scope of the audit, including making decisions about the locations the auditor will visit.

2.114 The QPR results indicated that analytical procedures used in planning were appropriate and were performed effectively. Furthermore, the results also indicated that the people involved in the analytical review process had the appropriate knowledge and skills to carry it out effectively. The QPR disclosed room for improved documentation of planning-stage analytical procedures in 14% of the engagements.

Analytical Procedures in the Overall Review

2.115 In the overall review stage of the audit, the objective of analytical procedures is to assist the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation. The auditor considers the adequacy of evidence gathered in response to unusual or unexpected balances or relationships identified in the planning and testing stages of the audit and

unusual or unexpected balances or relationships that were not previously identified. This overall review may indicate the need for additional evidence.

2.116 The QPR results paint a mixed picture of how well auditors perform analytical procedures in the final stage of the audit. In general, the analytical procedures performed were appropriate, the people involved had the requisite knowledge and skills, the thought process was thorough and considered the appropriate factors, and the timing of the analytical review was appropriate. However, the adequacy of inquiries and corroboration of explanations was questioned in 14% of the engagements reviewed. That, together with a perceived absence of sufficient documentation in 25% of the engagements reviewed, raised some doubt about the efficacy of the analytical review process at the completion of the audit.

Analytical Procedures as Substantive Tests

2.117 Analytical procedures that serve as substantive tests are used in many contexts. Some are used in combination with tests of details; others are used as the primary or only substantive tests. The selection of substantive analytical procedures can differ significantly between balance sheet accounts and income statement accounts. The procedures selected also may vary with the assessment of, and extent of testing undertaken on, internal control over a particular account or class of transactions.

2.118 The QPR disclosed that, in 73% of the key areas, substantive analytical procedures were predominantly supplemental procedures used in combination with tests of details. When the analytical procedures were the primary or only substantive tests, the QPR results indicated that ordinarily they were designed and performed appropriately.

2.119 In the five additional audit areas selected for each audit engagement, the QPR addressed whether substantive analytical procedures were the primary or sole substantive tests. For the most part, these five additional audit areas were not considered high-risk areas. The QPR results indicated that, in 75% of those areas, analytical procedures were *not* the primary or sole substantive procedures.

2.120 In the remaining 25% of the additional audit areas, analytical procedures were used as the primary or sole substantive tests. In 20% of these remaining areas, the QPR reviewers deemed the substantive analytical procedures insufficient to provide the necessary level of assurance. In these instances, the insufficient procedures related to the income statement, such as sales or revenue trends, gross profit ratios, and selling, general and administrative expenses. The QPR reviewers found that the analytical procedures were sufficient when they were employed as substantive tests of balance sheet areas. In those cases, the explanations of the results of the procedures generally were corroborated appropriately, and the procedures themselves were documented adequately. The QPR results generally reflect a belief by engagement personnel that, when analytical procedures were used as the primary or sole substantive tests of balance sheet accounts, they generated stronger evidence than when they were used as the primary or sole substantive tests of income statement accounts.

2.121 In assessing the mixed results of the QPR findings with respect to the use of analytical

procedures as substantive tests, the Panel observed that analytical procedures were not as effective as primary procedures when expectations were not properly developed, materiality thresholds for investigating differences were not clearly established, the analytical procedures were superficial or explanations were not corroborated,²³ and the documentation was inadequate. The Panel reviewed the firms' audit methodologies and guidance materials, guidance available from the AICPA in the form of a 1998 Audit Practice Release, *Analytical Procedures*, and other commercially available materials. All in all, the quantity of information on analytical procedures is impressive, yet the QPR disclosed practice issues of sufficient importance that the Panel concluded that the area needs attention.

* * * * *

2.122 The Panel noted that the degree of specificity in audit firms' methodologies and in their guidance on applying those methodologies varies significantly. It also appears to the Panel that a gap exists between (a) what is available in the firms' audit methodologies, professional standards and other guidance materials, and (b) what actually transpires in practice. The gap closes and the analytical procedures are more effective if a firm's audit methodology contains clear and unequivocal guidance requiring the appropriate use of analytical procedures in different circumstances (including guidance on the characteristics of the data to be used, establishing expectations, setting precision levels, employing explicit materiality thresholds, deciding on the desired levels of assurance and resolving differences). In addition to guidance materials and methodology, training auditors in the effective use of analytical procedures by using "real-life, practical, how-to" cases would appear to be invaluable.

Recommendations

To the Auditing Standards Board:

2.123 The Panel recommends that the ASB:

- Enhance auditing standards for analytical procedures to provide more specificity about what auditors need to do to design and perform analytical procedures in differing circumstances. The auditing standards should:
 - Provide guidance on how to design substantive analytical procedures for different types of accounts and assertions
 - Clearly articulate how relevant auditing concepts (e.g., the concepts of planning

²³ The Panel noted during its study of AAERs (see Appendix F) that the entities that engaged in the most sophisticated frauds ordinarily were very concerned about whether "the numbers and the relationships among them would 'look right' to the auditors" when they performed analytical procedures. Thus, these entities would "play around" with the numbers, often through the use of unsupported non-standard entries. In these circumstances, key ratios such as the accounts receivable and inventory turnover ratios and the gross margin percentages would meet the auditors' expectations rather than raising questions that might reveal the fraud. During its study of the AAERs, the Panel also noted instances where the auditors apparently over-relied on management's explanations for unusual fluctuations that the auditors noted when performing analytical procedures.

materiality, control risk assessment and testing of controls, and desired levels of assurance) influence the design and performance of analytical procedures

- Provide guidance on linking analytical procedures in the overall review stage to the auditor's conclusions reached in the audit and the sufficiency of the audit evidence that supports those conclusions
- Develop more guidance on when it is appropriate (and when it is inappropriate) for the auditor to rely on management's explanations during the course of the audit and on obtaining additional evidence to corroborate those explanations²⁴
- Specify appropriate documentation requirements

To audit firms:

2.124 The Panel recommends that audit firms:

- Ensure that their audit methodologies provide definitive guidance on analytical procedures. At a minimum, specific guidance should be provided in the following areas:
 - Developing expectations
 - Characteristics and reliability of different types of data
 - Using planning materiality in designing substantive analytical procedures
 - Establishing desired levels of assurance for substantive analytical procedures
 - Establishing precision levels that depend on the level of assurance the auditor desires from analytical procedures
 - Relating control risk assessments to the objectives of analytical procedures
 - Considering the role of account-level or assertion-level risk assessments (e.g., low-risk vs. high-risk assessments) in designing analytical procedures
 - The effect of the nature of particular accounts or assertions (e.g., balance sheet vs. income statement accounts) on analytical procedures
 - Identifying, investigating and evaluating the results of analytical procedures (including obtaining additional evidence to corroborate the responses to inquiries)

²⁴ The Canadian Institute of Chartered Accountants published a research report, *Audit Enquiry, Seeking More Reliable Evidence From Audit Enquiry* (2000), that, among other matters, studies the reliability of inquiry as an information-gathering technique. The ASB may wish to consider this research.

- Specifying the appropriate level of personnel assigned to perform analytical procedures, and the responsibilities of those assigned to review their work
- Assessing the results of analytical procedures in the final stage of the audit
- Documentation requirements consistent with the objectives of the analytical procedures
- Ensuring that training programs specifically address analytical procedures, are taken by all levels of audit personnel and employ “real-life, practical, how-to” case examples in varying circumstances that illustrate the firm’s methodology and guidance. Depending on levels of personnel, such training programs should include basic concepts of financial statement analysis as well as techniques used by analysts in evaluating the securities of different types of entities.

To the SECPS Peer Review Committee:

2.125 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Evaluate firms’ methodology, guidance and training materials relating to analytical procedures
- Determine whether firms have carried out the requisite training and evaluate the effectiveness of the firms’ implementation of their methodology related to analytical procedures on audit engagements
- Include their findings in this area in their reports to the SECPS Peer Review Committee

AUDITING REVENUE

Overview of GAAS

2.126 The 1999 COSO Report²⁵ noted that either premature revenue recognition or recognition of fictitious revenue occurred in approximately half of the cases of misstated financial statements reported in the SEC’s AAERs issued in the period 1987–1997.²⁶ Similarly, a substantial portion of litigation against audit firms reported to the SECPS Quality Control Inquiry Committee

²⁵ *Fraudulent Financial Reporting: 1987–1997, An Analysis of U. S. Public Companies*, research commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (1999 COSO Report).

²⁶ Revenue is used in its broadest sense to encompass, among others, sales of products or services, income from leasing property and income from investments.

involves revenue recognition issues. Finally, a study of recent SEC enforcement actions made on behalf of the Panel also indicated many problems related to revenue recognition.²⁷

2.127 Auditing standards generally do not prescribe procedures for auditing specific financial statement elements, and revenue is no exception. Auditing revenue starts with audit planning, and SAS No. 22, *Planning and Supervision*, requires the auditor to gain an understanding of the entity's business, internal control, types of products and services, related parties, locations, and production, distribution and compensation methods. Other SASs that are relevant to testing revenue deal with audit sampling, confirmations and other evidential matter, auditing accounting estimates, analytical procedures, management representations, related parties and using the work of a specialist.

2.128 In addition, in November 1998, the AICPA SEC Practice Section issued Practice Alert No. 98-3, *Revenue Recognition Issues*, and in January 1999 the AICPA staff issued a Notice to Readers, *Audit Issues in Revenue Recognition* (sometimes referred to as the revenue recognition "tool kit"). Both documents were intended to alert auditors to circumstances that could signal improper revenue recognition and to describe procedures that auditors can use to limit audit risk arising from improper revenue recognition.

2.129 The authoritative literature provides guidance on confirming receivables as a means of obtaining evidence that the receivables exist and are genuine. Since revenue often is recognized from transactions that concomitantly give rise to accounts receivable from a third party, confirming those receivables provides evidence that the revenue transactions actually occurred. SAS No. 67 provides guidance on selecting the items to be confirmed, designing the confirmation requests, communicating with the appropriate third party, and obtaining and evaluating the responses. SAS No. 67 establishes a rebuttable presumption that the auditor will confirm accounts receivable. SAS No. 67 also discusses alternative procedures when receivables are not confirmed.

Relevant Accounting Standards

2.130 Authoritative accounting guidance for recognizing revenue is mostly industry-specific and addresses such industries as franchising, software, construction contracting, real estate and leasing. The general guidance is sparse,²⁸ and the industry guidance is not wholly consistent. Some of the restatements of revenue in recent years could be characterized as resulting from a lack of clear guidance on how to deal with the many elements critical to revenue recognition,

²⁷ The Panel noted during its study of AAERs (see Appendix F) that approximately 70% of the cases in the study involved the overstatement of revenue, either from premature recognition or from recognizing fictitious revenue. This finding is consistent with the findings of the 1999 COSO Report and other studies. Appendix F describes the most frequent techniques noted for overstating revenue.

²⁸ Examples of general guidance on revenue recognition include Statement of Financial Accounting Concepts (SFAC) No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*; Accounting Principles Board Opinion No. 10, *Omnibus Opinion – 1966*; and Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists*.

such as the timing of delivery of products or services or the performance of activities over long periods of time.²⁹

2.131 Revenue has always been an important indicator of a company's vitality and growth prospects. Recently, however, revenue has taken on even more significance, as it has become the primary basis for valuing some companies' equity securities. For example, for some Internet-based companies without any current earnings or prospects for earnings in the short term, the market looks to surrogates for earnings or operating cash flows for valuation, and in some cases revenue is the surrogate.

2.132 In December 1999, the staff of the SEC issued Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, which summarizes certain of the staff's views on applying GAAP to revenue recognition in financial statements.³⁰ In addition to codifying the staff's views in some specific areas, such as "bill and hold" transactions, SAB No. 101 discusses broad principles of revenue recognition. Some observers have noted that the SAB is in apparent conflict with certain well-established practices.³¹

2.133 Further, in December 1999, the SEC asked the Emerging Issues Task Force to add to its agenda accounting for revenue-generating arrangements that include multiple deliverables of products or services.³² Expressing a view that allocations to deliverable elements should be based on relative fair values, the SEC also asked the ASB to develop guidance for practitioners on what constitutes sufficient, verifiable and objective evidence of fair values. The Panel understands that the ASB is developing an audit guide on revenue recognition.

Findings

2.134 The 1999 COSO Report, the information the Panel gathered from its analysis of AAERs and other litigation naming auditors all indicate a particular need for auditors to examine revenue transactions near the end of the period under audit. Also, auditors should be alert for indications of management override of controls with respect to period-end transactions. The COSO Report notes, "Findings suggest a continued need for evaluating and testing controls related to recording end-of-period accounts and transactions...."

2.135 The number of negative comments made by the QPR reviewers related to auditing revenue was relatively low, but generally was higher than in other areas. The specific aspects of auditing revenue for which the rate of negative responses was higher than in the other key areas included:

²⁹ The 1999 COSO Report noted, however, that half of the frauds that related to improper revenue recognition involved purely fictitious sales.

³⁰ SABs are not Commission rules or interpretations and are not officially approved by the Commission. They represent staff interpretations in administering the disclosure requirements of the federal securities laws. SABs are usually narrow in focus and issued in question and answer format. Because they are not official SEC rules, SABs are issued without exposure for comment.

³¹ For example, some observers would argue that the SAB gives greater weight than is necessary in many cases to contractual customer acceptance clauses in determining whether revenue recognition is appropriate.

³² As of August 2000, Emerging Issues Task Force Issue No. 00-21, *Accounting for Multiple-Element Revenue Arrangements*, was in an early stage of development.

- Obtaining a sufficient understanding of information systems and control activities, including consideration of the computer environment and processing, to identify and assess control risk
- The resultant assessment of control risk
- The appropriate involvement of information technology specialists in understanding, assessing and testing the information systems and control activities
- Focusing tests at the right controls
- The appropriateness of the nature, timing and extent of tests of controls

2.136 Despite these results, the QPR reviewers generally agreed that the resulting substantive tests were adequate because little reliance was placed on internal control, even when controls were tested. The reviewers noted, however, that a better understanding of the systems and controls might have led the auditors to design more effective or additional substantive tests.

2.137 There also were many positive findings. For example, the reviewers reported that they believed that appropriate consultation had occurred in all instances in which it was necessary (although the documentation could have been better), and that substantive analytical procedures were well executed.

2.138 Many respondents to the Panel's survey and commentators at the public hearings expressed the belief that auditors should pay more attention to, and be better trained in, accounting for and auditing revenue. One analyst opined that, unlike financial statement restatements resulting from other issues, revenue recognition issues may signal fundamental problems with the business.

Recommendations

To the Auditing Standards Board:

2.139 The Panel recommends that the ASB:

- Require that auditors test the cutoff of revenue when inherent or control risks relating to such transactions are other than low and specifically when there is a high level of sales transactions or individually significant sales transactions near the end of the reporting period. Cutoff tests should be more extensive than tests of only a few transactions before and after the close of the period. Cutoff testing often should require the auditor's physical presence at the entity's location(s) at period end.
- Clarify its standard on the confirmation process (SAS No. 67) to address the circumstances in which confirmation of the *terms* of transactions should be required.

The terms of revenue transactions should be confirmed whenever the transactions are individually significant and the risks associated with revenue recognition or the existence of receivables are high. This might be appropriate even if the auditor believes that confirmation of *balances* is ineffective.³³

- Give the highest priority to completing its proposed audit guide for revenue recognition

To audit firms:

2.140 The Panel recommends that audit firms:

- Test the cutoff of revenue when inherent or control risks relating to such transactions are other than low, and specifically when there is a high level of sales transactions or individually significant sales transactions near the end of the reporting period. Cutoff tests should be more extensive than tests of only a few transactions before and after the close of the period. Cutoff testing often should require the auditor's physical presence at the entity's location(s) at period end.
- Develop training materials, including case studies, focused on auditing revenue recognition issues in specific industries. Require professionals working on engagements in those industries to complete the training.

To the SECPS Peer Review Committee:

2.141 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Consider the adequacy of firms' policies, guidance and training (and any changes in them) in the area of auditing revenue recognition
- Include their findings in this area in their reports to the SECPS Peer Review Committee

To the Financial Accounting Standards Board:

2.142 The Panel recommends that the FASB add revenue recognition to its agenda. The Panel believes that an authoritative statement on the broad principles of revenue recognition is sorely needed. Because this may be a long-term project, in the interim the FASB (or other appropriate

³³ Confirmation of terms can be helpful in identifying the existence of any "side agreements," which the 1999 COSO Report identified as a significant factor in some misstatements of revenue, as did the Panel's study of AAERs (Appendix F).

bodies such as the Accounting Standards Executive Committee [AcSEC] or the Emerging Issues Task Force [EITF]) should identify and resolve or clarify areas of diverse or uncertain practice.³⁴

AUDITING ESTIMATES AND JUDGMENTS

Overview of GAAS

2.143 Financial statements generally are replete with accounting estimates and judgments. Concerns most frequently cited about auditing those estimates and judgments relate to restructuring and merger-related reserves³⁵ and the use of those and other reserves to “manage” earnings.

2.144 The Panel is aware of a research study on earnings management nearing completion.³⁶ That study indicates that, although many financial frauds are related to revenue recognition, manipulation of reserves is the technique most frequently used to manage earnings (see Chapter 3).

2.145 SAS No. 57, *Auditing Accounting Estimates*, defines an *accounting estimate* as an approximation of a financial statement element, item or account.³⁷ It describes aspects of an entity’s internal control that may reduce the likelihood of material misstatements of accounting estimates, and contains guidance for evaluating (a) whether management has identified all accounting estimates that could be material to the financial statements and (b) the reasonableness of an estimate.

2.146 The SAS states that, in evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches: (a) review and test the process used by management to develop the estimate, (b) develop an independent expectation³⁸ of the estimate to corroborate the reasonableness of management’s estimate, and (c) review subsequent events or transactions occurring prior to completion of fieldwork. SAS No. 57 also

³⁴ The Panel understands that the FASB has received a number of requests to add a project specifically on revenue recognition, and that the FASB is considering them as part of its agenda-decision process. Also, AcSEC recently has issued industry-specific revenue recognition guidance, and the EITF is addressing some revenue recognition and financial display issues.

³⁵ The term *reserves* is used in this report to refer to allowances for estimated losses that are displayed either as liabilities (e.g., a product warranty reserve) or as reductions of assets (e.g., a loan loss reserve). Modern usage generally avoids the term *reserves* in financial statements, and instead refers to “estimated liabilities” and asset “allowance” accounts. The term *reserves*, however, continues to be widely used in other contexts. It sometimes is used pejoratively to suggest abuses in earnings management. This is not the Panel’s intent.

³⁶ A study by Mark W. Nelson and John A. Elliot of Cornell University, and Robin L. Tarpley of George Washington University.

³⁷ SAS No. 57 states that “accounting estimates are often included in historical financial statements because (a) the measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events or (b) relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis.”

³⁸ See “Analytical Procedures” in this chapter for a discussion of the concept of developing expectations, and related recommendations to the ASB.

provides guidance on how to review and test management's process (including the possibility of using the work of a specialist regarding certain assumptions).

Unique Audit Problems

2.147 There are at least three reasons why it is difficult to audit accounts involving estimates and judgments.

2.148 First, there may be little "hard" evidence supporting the amounts. Unlike a transaction with a third party, there is seldom any external documentation, such as a contract, invoice or purchase order. Except in a few instances, the authoritative accounting literature has no required minimum levels of documentation to support the establishment of or subsequent activity in reserves.³⁹ Sometimes the only significant documentation may be that prepared by auditors to support their conclusions.

2.149 Second, the amounts involve subjective estimation and judgment.⁴⁰ Unlike most third-party transactions, the amounts involved are not fixed. They may be based on a range of potential results, and reasonable people may disagree on the most likely outcome or amount.

2.150 Third, activity in reserves may be driven principally by management's intentions and decisions rather than by external events or transactions. (For example, management has the ability to determine whether it will offer to settle outstanding litigation.) Indeed, determining just when management's intentions create a liability has vexed accountants and auditors for decades, and, for example, has been a significant factor in the uncertainties surrounding the accounting for restructuring and similar reserves.

Relevant Accounting Standards

2.151 The principal accounting guidance for reserves is Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, issued in 1975.⁴¹ That statement calls for the accrual of a loss contingency when it is *probable* that an asset has been impaired or a liability incurred at the date of issuance of the financial statements and the loss can be *reasonably estimated*. General or unspecified business risks do not meet these conditions for accrual. Inappropriate reserves also include (a) amounts accrued in excess of those meeting the SFAS No. 5 conditions and (b) amounts maintained in reserves that are not reversed into income after the event for which they had been established occurred or failed to occur.

³⁹ Among the accounting pronouncements on estimates and judgments that do address documentation are: EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)* (see note 42); EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*; and SAB No. 100, *Restructuring and Impairment Charges*. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, although unrelated to reserves, addresses the appropriate documentation when management designates financial instruments as hedges.

⁴⁰ Because of the pervasiveness of estimates, AICPA Statement of Position 94-6, *Disclosure of Certain Risks and Uncertainties*, requires disclosure (a) that the preparation of financial statements in conformity with GAAP requires the use of management's estimates and (b) when it is reasonably possible that a material change in estimate will occur in the near term.

⁴¹ Additional guidance includes FASB Interpretation No. 14, *Reasonable Estimation of a Loss*.

2.152 SFAS No. 5 offers little clarification as to when management’s intent can result in an asset having become impaired or a liability having been created. Certain accruals that are triggered in part by management intent are addressed in the literature.⁴² In other cases, it may be difficult to distinguish between the appropriate accrual of a loss contingency based on GAAP and an inappropriate accrual of future expenses.⁴³

2.153 Another apparent area of confusion is the belief by some that reserves are “fungible,” and are therefore “allocable” to financial statement accounts other than those for which the reserves were established initially. For example, a company with an excess income tax accrual and an understated allowance for doubtful accounts might “reallocate” the tax reserve, rather than reversing the unneeded tax accrual into income and separately accruing a provision for doubtful accounts. Similarly, an unused or excessive restructuring reserve might be used to offset the cost of a new restructuring. Such reallocations are not appropriate under SFAS No. 5; rather, GAAP would require separate accounting and disclosure of both amounts, if material.

2.154 In his testimony at the Panel’s open hearings, the chairman of the FASB noted that there is a direct relationship between the effectiveness of accounting standards and the financial reporting system on the one hand, and the ability of auditors to be effective on the other hand. The Panel agrees. It appears to the Panel that the confusion (warranted or not) over the appropriate application of SFAS No. 5 and related guidance, such as that for restructuring and similar reserves, may reduce audit effectiveness. Among the matters that could be clarified are:

- Which future expenses or operating losses qualify for loss accrual when management intends or commits to incur them? (That is, when does management intent create a liability?)
- What is the “date of issuance” of financial statements for purposes of loss accruals?⁴⁴

⁴² See, for example, Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*; EITF Issue No. 94-3 (see note 39); and SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. On June 30, 2000, the FASB issued a proposed SFAS related to asset impairment and disposal issues that would supersede most or all of the preceding three standards. Under this proposal, an entity’s commitment to a plan would not be sufficient to recognize liabilities associated with disposal activities; the definition of a liability in SFAC No. 6 also would have to be met.

⁴³ An example of the latter would be the accrual of incremental or redundant future costs, such as the anticipated costs of running parallel accounting systems during the introduction of a new system. (To illustrate the point in the extreme, if expenses that are only “committed” could be accrued, then, arguably, next year’s budget might be accruable because such expenses are both probable and estimable.)

⁴⁴ The Panel understands that there have been widely differing views as to the date of issuance, ranging from a public release of earnings to the filing of a Form 10-K or 10-Q. The Panel is aware that in December 1999 the SEC staff indicated its general view that financial statements are “issued” as of the date they are distributed for general use and reliance, and that a press release of earnings does not constitute issuance. However, that may present significant public policy questions: Should the investing community view all earnings releases as tentative? Should they be considered subject to change for revisions of estimates for events that may occur between the release of earnings and an uncertain future date? The Panel doubts that this view is understood by investors today and believes that investors base decisions on earnings releases, which are assumed to be reliable unless otherwise indicated.

- Are there minimum levels of documentation that entities should prepare regarding activity in reserves? Examples of minimum documentation might include a description and the dates of the specific event or events that caused the reserve activity, an analysis of compliance with SFAS No. 5 and other relevant standards, and approvals by appropriate levels of authority.
- Are there minimum levels of homogeneity and other characteristics that must exist for contingent losses to be collectively evaluated? (To what extent – if any – are reserves “fungible” or “allocable”?)

2.155 In January 2000 the SEC proposed changes to clarify and expand disclosures related to changes in certain reserves.⁴⁵ The proposal also would reposition the disclosures (which companies currently present in a schedule) to the forepart of the filing document.

Findings

2.156 The QPR reviewers found that the most effective auditing of amounts subject to estimation and judgment occurred when the senior members of the engagement team (including the engagement and concurring partners, designated consulting partners and functional specialists) were involved significantly and on a timely basis. The reviewers reported positive findings in the areas of risk assessment and linkage of those assessments to substantive tests. The matters cited most frequently for potential improvement involved documentation and corroboration of management’s representations and responses to inquiries. Because the audit evidence usually is generated internally, management’s representations often are critical to the audit process, although the auditor should corroborate those representations. The reviewers did not find widespread development of independent expectations related to reserves, one of the techniques suggested by SAS No. 57 for evaluating the reasonableness of estimates. Finally, in some instances the reviewers were concerned that not all issues related to reserves had been resolved appropriately. In those few instances, the reviewers were satisfied nonetheless that the overall audit results were satisfactory.

2.157 The QPR disclosed that auditors generally did not document internal control in the area of reserves. An entity’s lack of specific controls related to accounting estimates – including documentation and adequate review and approval by appropriate levels of authority – presents an audit issue as well as a possible matter to be communicated to the entity.⁴⁶ In some instances, the QPR reviewers noted confusion or misunderstanding by both the entity and the auditors about the appropriate application of the relevant accounting standards.

2.158 Many respondents to the Panel’s survey and speakers at the public hearings urged more

⁴⁵ *Proposed Rule: Supplementary Financial Information* (Release Nos. 33-7793 and 34-42354), January 21, 2000.

⁴⁶ The auditor should consider whether such a situation could represent a *reportable condition* that should be communicated to the audit committee (SAS No. 60, *Communication of Internal Control Related Matters in an Audit*). A registrant’s lack of controls and related documentation potentially might constitute a violation of Section 13(b)(2)-(7) of the Securities Exchange Act of 1934 (known as the “books and records and internal control provisions” section of the Foreign Corrupt Practices Act of 1977), which requires keeping books, records and accounts in reasonable detail and devising and maintaining a sufficient system of internal control.

auditor involvement in entities' reporting of reserves in their interim financial statements. Some noted that financial frauds often originate in interim periods. The SEC recently adopted rules requiring reviews of interim financial information by the company's independent auditors before that information is filed with the SEC. The Panel believes this should improve financial reporting and audit effectiveness.

2.159 Some participants in the Panel's study noted that many accounting standards involving accounting estimates are complex and require a significant amount of judgment.⁴⁷ In establishing new standards, the FASB evaluates (among other things) the cost-effectiveness of requiring additional accounting information. Some have expressed concern that FASB standards are increasingly difficult not only to implement but also to audit. On the one hand, the FASB may receive few, if any, comments regarding audit practicability during the period of exposure of proposed standards. On the other hand, auditors may not be able to identify all of the issues until a new standard is implemented and the results first audited. The Panel understands that there is communication between the staffs of the ASB and the FASB as audit issues related to new standards are identified. Those efforts often take place after the standards have been issued, however, and there is little formal assessment of the auditability of proposed accounting standards.

Recommendations

To the Auditing Standards Board:

2.160 The Panel recommends that the ASB:

- Provide detailed guidance regarding the auditing of reserves.⁴⁸ The Panel understands that the ASB intends to prepare a guide for auditing reserves along the lines of the Notice to Readers, *Audit Issues in Revenue Recognition*, that it issued in 1999. The Panel urges the ASB to assign a high priority to this effort and provide guidance on

⁴⁷ Recent examples include:

- SFAS No. 109, *Accounting for Income Taxes* – Measurement of deferred tax assets is based on an assessment of whether realizability is “more likely than not.” In certain circumstances, the assessment must include tax planning strategies that meet certain criteria, which expands even further the judgment required.
- SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* – Both recognition and measurement of impairment may be based on forecasts of future cash flows.
- SFAS No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* – Determination of whether an asset has been sold or a liability extinguished may depend on complicated legal determinations. Auditors must assess whether legal opinions support those determinations.
- SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* – All derivatives are recognized and measured at fair value. Techniques for valuation may be intricate, and may include expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

⁴⁸ The Panel notes that in December 1999 the Chief Accountant of the SEC recommended that the ASB add this project to its agenda. He indicated that the SEC was aware of audit problems involving reserves and suggested areas where additional guidance was needed.

what constitutes sufficient evidence to support reserve balances and activity, including what is needed to corroborate documentation generated by the entity.

- Establish a protocol to assess the auditability of proposed accounting standards prior to their issuance. Any field tests of proposed standards also should include evaluations of their auditability. Further, the liaison between the ASB and the FASB that exists currently should be made formal to help ensure timely identification of and reaction to audit issues related to accounting standards.⁴⁹

To audit firms:

2.161 The Panel recommends that audit firms:

- Provide training on the application of SAS No. 57 and the provisions of SFAS No. 5 and related guidance
- Encourage engagement teams to apply audit tests to reserve activity on a timely basis – for example, during the performance of interim reviews
- Adopt policies or internal guidance that promotes partner and manager involvement in the evaluation of reserve activity during interim reviews (if they do not already have such policies or guidance)

To the SECPS Peer Review Committee:

2.162 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Evaluate firms' policies, training and guidance materials on auditing estimates and judgments
- Include their findings in this area in their reports to the SECPS Peer Review Committee

To the Financial Accounting Standards Board:

2.163 The Panel recommends that the FASB:

⁴⁹ AcSEC issues comment letters on behalf of the AICPA on standards proposed by the FASB. These letters usually are limited to accounting matters and generally do not address implementation or auditability issues. This may occur because of an often-held view that, if an accounting standard can be implemented by financial statement preparers, the results also can be audited. The Panel recognizes that the current staff levels and structure of the ASB do not lend themselves to easy implementation of this recommendation. For the most part, the profession has looked to the firms to identify implementation and auditability issues and to forward them directly to the FASB. Nonetheless, the Panel believes that AcSEC and the ASB should analyze both the accounting and auditing aspects of proposed accounting standards.

- Clarify the accounting for contingencies to enable more consistent application of the criteria for accruing losses.
- Establish a protocol with the ASB to assess the auditability of proposed accounting standards before they are issued, including evaluations of auditability when proposed standards are field tested
- Formalize the existing liaison between the ASB and the FASB to help ensure timely identification of and reaction to audit issues arising from newly issued standards

To audit committees:

2.164 The Panel recommends that audit committees evaluate the nature of entities’ reserves and review activity in them with both management and the auditors.

MATERIALITY, WAIVED ADJUSTMENTS AND ANALYSTS’ EXPECTATIONS

Overview of GAAS

2.165 SAS No. 47 recognizes that the auditor may become aware of misstatements during the audit that, individually and in the aggregate, are not material to whether the financial statements are presented fairly in conformity with GAAP.⁵⁰ The SAS instructs the auditor to aggregate the misstatements that the entity has not corrected in a way that enables him or her to consider whether, in relation to individual amounts, subtotals or totals in the financial statements, they materially misstate the financial statements taken as a whole. SAS No. 47 points out that there are both qualitative as well as quantitative aspects of materiality.

2.166 In recent years there have been numerous instances of the price of a company’s stock dropping precipitously when the company failed to meet analysts’ earnings forecasts by only a penny or two a share, or failed to meet their revenue forecasts. The Chairman and the Chief Accountant of the SEC, among others, have expressed concerns that some entities may have been “managing” their earnings inappropriately (often referred to as “earnings management”) in order to meet analysts’ forecasts and thereby avoid a precipitous drop in the price of their stock. They also have expressed concern that auditors have not challenged these actions, but instead

⁵⁰ Paragraph 132 of SFAC No. 2, *Qualitative Characteristics of Accounting Information*, describes the concept of *materiality* as follows: “The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.” This formulation is in substance equivalent to the holding of the U.S. Supreme Court (*TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 [1976]) that a fact is material if there is “a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” Each Statement of Financial Accounting Standards adopted by the FASB states, “The provisions of this Statement need not be applied to immaterial items.”

have “waived” known potential misstatements of earnings or revenue because the amounts involved were quantitatively immaterial.

2.167 In August 1999, the staff of the SEC issued SAB No. 99, *Materiality*, which states that entities and auditors should not rely exclusively on quantitative benchmarks, such as 5% of net income, to determine whether an item, or the aggregation of items, is material to the financial statements. The SAB describes various qualitative factors (e.g., whether a misstatement affects the trend of earnings, whether analysts’ forecasts are met and whether a loan covenant is violated) that also should be considered when making materiality decisions.

2.168 In December 1999, the ASB issued SAS No. 89, *Audit Adjustments*, which requires the representation letter that the auditor obtains from management to include an acknowledgment by management that it has considered the misstatements aggregated by the auditor and concluded that any uncorrected misstatements (often referred to as waived adjustments) are immaterial. The SAS also requires that a summary of the waived adjustments be included in or attached to the representation letter and that those misstatements be reported to the audit committee.

Findings

2.169 The QPR reviewers determined whether the audit engagement teams were aware of and considered analysts’ forecasts, especially when evaluating waived adjustments. The reviewers also considered whether they agreed with the engagement teams’ conclusions that it was appropriate to waive the uncorrected misstatements and whether waiving the adjustments enabled the companies to meet analysts’ forecasts.

2.170 The QPR found that analysts’ forecasts were publicly available for 60% of the audits reviewed. The QPR reviewers reported that the engagement team considered those forecasts when evaluating waived adjustments on 60% of the engagements for which analysts’ forecasts were available. (During the QPR, the Panel became aware that one firm provides all its engagement partners with the latest information regarding analysts’ forecasts, as well as the entity’s latest earnings announcements, for each of their clients.)

2.171 The QPR reviewers reported that waiving the adjustments did not affect whether the company met the analysts’ forecasts on 66% of the engagements reviewed where analysts’ forecasts were publicly available, that they could not ascertain whether waiving the adjustments affected whether the company met the forecasts on 33% of the engagements reviewed where analysts’ forecasts were publicly available, and that waiving the adjustments may have affected whether the company met the analysts’ forecasts on, at most, only one of the engagements reviewed.

2.172 The QPR reviewers generally agreed with the engagement team’s conclusions that it was appropriate to waive the proposed adjustments and with the engagement team’s reasons for waiving them. The reviewers also generally agreed that the upper-level engagement team members (ordinarily the engagement partner, concurring partner, manager and in-charge accountant) thoroughly reviewed the summary of waived adjustments, and that the engagement team thoroughly discussed the waived adjustments with upper-level entity management.

2.173 In those few situations (approximately 4% of the engagements reviewed) in which the QPR reviewer did not agree with the engagement team’s conclusion that it was appropriate to waive the proposed adjustments, either the reviewer was satisfied that the waived adjustments did not have a material effect on the overall financial statements or the matter was referred to the firm for appropriate resolution.

2.174 The Panel understands that the ASB currently is working on a project to update the auditing standards as they relate to materiality in view of the issuance of SAB No. 99 and changing views regarding the criteria for determining whether an item is material.⁵¹

2.175 The QPR reviewers reported that the audit firms treat proposed adjustments differently in judging whether they are material. Some firms use the so-called “iron curtain” approach, in which the effects of all (cumulative) uncorrected misstatements are deemed to affect the current period’s income statement as well as the balance sheet. Other firms use the so-called “rollover” approach in which the cumulative uncorrected misstatements, net of the uncorrected misstatements carried over from the prior year (i.e., “rolled over”), are deemed to affect the current period’s income statement. The balance sheet effects are the same under both methods. Both techniques are permitted under SAS No. 47. While good arguments can be made for either method, the Panel believes that permitting both methods is potentially confusing, especially in view of the provisions in SAS No. 89 requiring that waived adjustments be addressed in management’s representation letter and be reported to the audit committee.

2.176 The Panel believes, based on its own observations and experience, the focus group discussions and interviews with audit professionals during the QPRs and in other forums, that auditors will improve their understanding of the entity’s control environment, business and industry if they are aware of analysts’ forecasts and reports on the entity, the information management provides to the analysts, and management’s policies and processes for communicating that information.

Recommendations

To the Auditing Standards Board:

2.177 The Panel recommends that the ASB:

- Provide additional authoritative guidance to assist auditors in determining whether identified misstatements are material. (The Panel understands the ASB is considering this subject.)
- Specify, in cooperation with the FASB if necessary, that there be only one method of handling prior periods’ uncorrected misstatements when determining whether proposed adjustments are material. (The Panel understands that this matter is on the

⁵¹ The Panel has not attempted to assess all of the implications of SAB No. 99, which was issued after the audits covered in the QPR were conducted and the related audit reports issued.

ASB's agenda and recognizes that the ASB and FASB likely would need to develop an appropriate method of transitioning to the chosen method.)

- Require the auditor to consider published analysts' reports and forecasts (in addition to other information) when gaining an understanding of the entity's business and industry, assessing risks and considering whether the effects of identified misstatements are qualitatively material.

To audit firms:

2.178 The Panel recommends that audit firms adopt policies (unless they already have done so) requiring engagement teams to:

- Obtain analysts' reports and forecasts as part of gaining an understanding of the entity's business, consider the effects of those forecasts and the information in those reports when assessing risks and evaluating important issues, and include them among the factors considered when evaluating the materiality of potential adjustments
- Obtain an understanding of the entity's policies and processes, if any, for communicating information to analysts
- Become aware of the information management provides to analysts, such as by reading transcripts of the presentations or by listening to management's presentations to analysts when the presentations are available by telephone, videotape, the Internet or other public communications vehicles

To the SECPS Peer Review Committee:

2.179 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Evaluate the effectiveness with which engagement teams implement SAS No. 89 and SAB No. 99 and determine whether additional guidance or training is needed
- Review and evaluate firms' policies, if any, for understanding the entity's policies and processes for communicating information to analysts; obtaining analysts' reports and forecasts, and considering them when assessing risks and evaluating important issues and the materiality of potential adjustments; and becoming aware of the information management provides to analysts
- Evaluate the effectiveness with which engagement teams implement their firm's policies and determine whether additional guidance or training is needed

- Include their findings in this area in their reports to the SECPS Peer Review Committee

GOING CONCERN CONSIDERATIONS

Overview of GAAS

2.180 Financial statements are prepared on the assumption that the entity will continue as a going concern. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires the auditor to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.⁵² Conditions and events identified through the performance of audit tests over the course of the audit are considered in the aggregate to determine whether there could be such doubt.⁵³ In the face of such doubt, the auditor expands the audit tests to obtain evidence about management's plans that are intended to mitigate the effects of the identified conditions and events, and assesses the likelihood that such plans can be implemented effectively.⁵⁴ After evaluating management's plans, the auditor should conclude whether substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time. If substantial doubt exists, an explanatory paragraph is included in the auditor's report.

2.181 Authoritative accounting pronouncements contain no explicit going concern disclosure requirements. The established practice is for the entity to include going concern disclosures in the financial statements. SAS No. 59 requires that an auditor consider the adequacy of any going concern disclosures in the financial statements, whether or not an explanatory paragraph has been added to the auditor's report. Such disclosures might include the conditions and events giving rise to the assessment of substantial doubt, including their possible effects and management's evaluation of their significance, mitigating factors, possible discontinuance of operations, and management's plans.

2.182 SAS No. 59 does not require an auditor to predict future conditions or events, and states that the absence of a reference to substantial doubt in an auditor's report should not be viewed as providing assurance that an entity will continue as a going concern.

⁵² "A reasonable period of time" is defined in SAS No. 59 as a period of time not to exceed one year beyond the date of the financial statements being audited, and often is referred to as the one-year time horizon in SAS No. 59. The concept also is recognized in Section 10A(a) of the Securities Exchange Act of 1934, as amended, which requires that the auditor evaluate whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

⁵³ These conditions and events may include negative trends (e.g., recurring operating losses, working capital deficiencies, negative cash flows from operating activities or adverse key financial ratios), indications of financial difficulties (e.g., default on loan agreements, restructuring of debt or need to seek new sources or methods of financing), internal matters (e.g., work stoppages or substantial dependence on the success of a particular project) or external matters (e.g., legal proceedings that might jeopardize an entity's ability to operate, loss of a key license or patent, or loss of a principal customer).

⁵⁴ Management's plans may include plans to dispose of assets, borrow money, restructure debt, reduce expenditures or increase equity ownership.

Findings

2.183 The QPR reviewers sought to assess whether engagement teams were alert to the audit risks relating to an entity's liquidity, particularly when there may have been substantial doubt about an entity's ability to continue as a going concern or when there were severe concerns about the entity's liquidity. Indications of significant audit risks involving the entity's viability existed on 49 of the 126 QPR engagements. For these 49 engagements, QPR reviewers made inquiries specifically targeted at the audit risks and issues resulting from concern about the entity's viability.

2.184 The reviewers agreed that in all cases the engagement teams were alert to the presence of information that could give rise to the need to evaluate whether there was substantial doubt about the entity's ability to continue as a going concern, evaluated management's plans in sufficient depth, reached supportable conclusions regarding the entity's ability to continue as a going concern, and gave appropriate consideration to the need for financial statement disclosure when the substantial doubt was alleviated. Generally, reviewers agreed with engagement teams' decisions regarding the need to consult and the depth of such consultations.

2.185 Similar to other areas in the QPR, corroboration of management's representations and, more frequently, documentation were cited as areas needing improvement, particularly in connection with the evaluation of prospective financial information that was significant to management's plans. Even in those cases, however, the reviewers still agreed with the engagement teams' overall conclusions.

2.186 In addition to evaluating the generally positive QPR results, the Panel considered factors in the current economic environment that highlight the importance of the auditor's going concern responsibilities. Some entities, particularly certain service- and technology-based "new economy" companies, rely heavily on the availability of external financing, rather than profitable operations, for continuing in business. The current economic climate has accommodated these entities, but that could change quickly. Liquidity pressures can arise quite suddenly, raising the question of the adequacy of financial statement disclosures about financial flexibility and the possible consequences on an entity's going concern status. Furthermore, formalizing the notion that management, not the auditor, has the primary responsibility for going concern assessments and disclosures would provide a sound conceptual underpinning for users' understanding of the going concern concept. As a result, the Panel concluded that, in addition to its recommendations designed to improve audit performance, it should address certain of its recommendations to the FASB.

Recommendations

To the Auditing Standards Board:

2.187 The Panel recommends that the ASB provide expanded guidance and specific examples of the auditing procedures to be performed and the audit evidence to be obtained when considering management's plans for mitigating the adverse effects of conditions and events that raised the auditor's substantial doubt about the entity's ability to continue as a going concern.

Particular consideration should be given to circumstances in which reliance is placed on proposed cost reductions and other prospective financial information.

To audit firms:

2.188 The Panel recommends that audit firms incorporate the following matters into their training programs and audit methodologies:

- Specific guidance on considering management’s plans for mitigating the adverse effects of conditions and events that created the auditor’s substantial doubt about the entity’s ability to continue as a going concern, including guidance on evidence supporting proposed cost reductions or other prospective financial information
- Practice aids, such as a template for confirming plans involving third-party financial support, and “real-life” examples of evidential matter that corroborates representations regarding management’s plans, as well as examples of evidential matter that does not

To the SECPS Peer Review Committee:

2.189 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Evaluate the adequacy of firms’ guidance and training (and any changes in them) in the area of going concern considerations
- Include their findings in this area in their reports to the SECPS Peer Review Committee

To the Financial Accounting Standards Board:

2.190 The Panel recommends that the FASB:

- Define the *going concern concept* and clarify that management, not the auditor, has the primary responsibility to assess whether the entity has the ability to remain a going concern⁵⁵
- Consider the appropriateness of the one-year time horizon in SAS No. 59. The FASB

⁵⁵ The Panel notes that international accounting standards (IASs) require that management make an assessment of an enterprise’s ability to continue as a going concern and disclose material uncertainties about its ability to do so (IAS 1, *Presentation of Financial Statements*, revised 1997, under the caption “Going Concern”). Similarly, international auditing standards (ISAs) require auditors to evaluate management’s assessment of the entity’s ability to continue as a going concern and the adequacy of disclosures (ISA 570, *Going Concern*, revised 1999). The ISA cites IAS 1 as a source of guidance on such assessments and disclosures. (For a discussion of international accounting and auditing standards, see Chapter 7.)

should evaluate this time horizon and recognize its importance to auditors in framing their audit reports.

- Promulgate explicit going concern disclosure requirements to fit various circumstances. Such requirements should include disclosures about the entity's reliance on the financial support of related or third parties to mitigate the adverse effects of conditions and events that create substantial doubt about the entity's ability to continue as a going concern.

INTERNAL AUDITORS

2.191 Internal auditors are responsible for providing analyses, evaluations, assurances, recommendations and other information to an entity's management and audit committee or others with equivalent authority and responsibility. To fulfill this responsibility, internal auditors must be objective with respect to the activity being audited. Although the objectives of internal audit are multi-faceted and vary from company to company, most internal audit functions monitor the performance of the entity's controls.

2.192 The Panel believes that an internal audit function that focuses on financial reporting matters can improve the quality of financial reporting. It acknowledges the importance of this function and encourages a high degree of coordination and cooperation between internal and external auditors. This coordination ideally includes communications concerning inherent, control and fraud risks. Cooperation will need to increase as information systems become more sophisticated, resulting in greater emphasis on controls, particularly in developing interim financial information.

Overview of GAAS

2.193 SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance on the external auditor's use of internal audit. It requires the external auditor to obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit.

2.194 If, after obtaining an understanding of the internal audit function, the external auditor concludes that the internal auditors' activities are not relevant to the financial statement audit, the external auditor does not have to give further consideration to the internal audit function, unless the external auditor requests direct assistance from the internal auditors. Even if some of the internal auditors' activities are relevant to the audit, the external auditor may conclude that it would not be efficient to consider further the work of the internal auditors. If the external auditor decides that it would be efficient to consider how the internal auditors' work might affect the nature, timing and extent of audit tests, the external auditor should assess the competence and objectivity of the internal audit function. The internal auditors' work may affect the procedures that the external auditor performs in obtaining an understanding of the entity's internal control and assessing risk, and the substantive tests he or she performs.

2.195 When the work of the internal auditors is expected to affect the audit, the external auditor should consider the extent of the effect, coordinate the audit work with the internal auditors, and evaluate and test the effectiveness of the internal auditors' work. These tests may be accomplished by either (a) examining some of the controls, transactions or balances that the internal auditors examined or (b) examining similar controls, transactions or balances not actually examined by the internal auditors.

2.196 In performing the audit, the external auditor may request direct assistance from the internal auditors. This direct assistance relates to work that the external auditor specifically requests the internal auditors to perform to complete some aspect of the external auditor's work. When direct assistance is provided, the external auditor should assess the internal auditors' competence and objectivity, and, to the extent appropriate in the circumstances, supervise, review, evaluate and test the work performed by the internal auditors.

Findings

2.197 The QPR reviewers reported that, on 16% of the engagements reviewed, the external auditors made significant use of the work of internal audit, or used internal audit to provide direct assistance to the engagement team to document internal control, test internal control or perform substantive tests of details.

2.198 The reviewers generally agreed that the people involved in assessing the overall effectiveness of internal audit and reviewing its work had the appropriate knowledge and skills to do so, that the engagement teams had a sufficient basis for making use of the work of internal audit or for using internal audit to provide direct assistance to the engagement team, and that the engagement team's review of the direct-assistance work was sufficient to support its use. Some questioned the sufficiency of the engagement team's review of the direct-assistance work and whether adequate retesting of internal audit work was performed.⁵⁶

Recommendations

To the Auditing Standards Board:

2.199 The Panel recommends that the Auditing Standards Board revise SAS No. 65 to establish more definitive and specific criteria and requirements for testing the work performed by internal audit.

To audit firms:

2.200 The Panel recommends that audit firms:

- Review the adequacy of their policies requiring auditors to test the work performed

⁵⁶ The Panel noted during its study of AAERs (see Appendix F) a very limited number of situations in which the external auditors may not have tested, supervised and reviewed the internal auditors' work as thoroughly as would have been desirable.

by internal audit and to document their work relating to internal audit

- Consider during their internal inspection programs whether engagement teams are using the work of internal audit excessively, especially on large engagements

To the SECPS Peer Review Committee:

2.201 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Address the adequacy of firms' policies, procedures and guidance on the testing of internal audit work and the documentation of auditors' considerations and work related to internal audit
- Include their findings in this area in their reports to the SECPS Peer Review Committee

COMMUNICATING WITH AUDIT COMMITTEES

Background and Overview of GAAS

2.202 Audit committees of boards of directors have become a well-recognized and important element in the governance of U.S. public entities and increasingly of entities in other countries.

2.203 The SEC has long supported strong, independent audit committees. In 1974 and 1978, the SEC adopted rules requiring annual disclosures about the existence and composition of the audit committee, the functions it performed, and the number of meetings it held. In 1999, the SEC adopted new rules and amendments that, among other things, require companies to include reports by their audit committee in their proxy statements and disclose whether their audit committee is independent and has a charter. Listing requirements of the New York Stock Exchange, the American Stock Exchange and the NASDAQ national market require that listed companies have audit committees with membership limited solely to independent directors.

2.204 The skills and experience required of audit committee members, as well as the committees' roles, responsibilities and operating practices, historically have not been specified by the stock exchanges or the SEC. "Best practices" have evolved over time and have been published by various professional organizations and firms. Audit committees, the independence of committee members and committee best practices have been studied in depth, most notably by the National Commission on Fraudulent Financial Reporting,⁵⁷ the Advisory Panel on Auditor

⁵⁷ *Report of the National Commission on Fraudulent Financial Reporting*, October 1987.

Independence,⁵⁸ and the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.⁵⁹

2.205 Several auditing standards govern independent auditors' communications with audit committees. In general, SAS No. 61, *Communications With Audit Committees*, establishes auditor communication requirements relating to financial statements and other information in documents containing audited financial statements. Those requirements also include informing audit committees about significant accounting policies and their application, management judgments and the process used in formulating particularly sensitive accounting estimates, significant audit adjustments, disagreements with management, consultation by management with other accountants, major issues discussed with management prior to being retained, and difficulties encountered in performing the audit. The ASB recently amended SAS No. 61 with SAS No. 89, *Audit Adjustments*, and SAS No. 90, *Audit Committee Communications*. SAS No. 89 requires auditors to communicate to audit committees uncorrected misstatements whose effects management believes are immaterial. SAS No. 90 requires auditors to discuss with the audit committee their judgments about the quality, not just the acceptability, of the entity's accounting principles and the estimates underlying its financial statements. In addition, auditors are required to attempt to discuss with the audit committee certain matters identified in their quarterly review of interim financial information before it is filed with the SEC.

2.206 SAS No. 54, *Illegal Acts by Clients*, requires auditors to assure themselves that audit committees are adequately informed about illegal acts that come to the auditors' attention. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, calls for reporting to the audit committee fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements.

2.207 The SECPS requires its member firms to report annually to audit committees the total fees received by the audit firm for management advisory services during the year under audit. In addition, Independence Standard No. 1, *Independence Discussions with Audit Committees*, calls for auditors to discuss with and confirm to audit committees their independence and disclose all relationships between the auditor and the entity that in the auditor's professional judgment may reasonably bear on independence.

Findings

2.208 The QPR revealed that audit committees had been established for all but five of the 126 public entities whose audits were reviewed. The reviewed engagements included eight companies where no committee meetings were held during the year and eight where the reviewers considered the number of meetings (typically one) to be inadequate. There were three additional instances in which the reviewers questioned the timeliness of the meetings.

2.209 The QPR reviewers addressed the following areas:

⁵⁸ *Strengthening the Professionalism of the Independent Auditor*, Report to the Public Oversight Board of the SEC Practice Section, September 1994.

⁵⁹ *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 1999.

- The substance of the audit engagement partner's relationship with the committee chair
- The timeliness, frequency and quality of interaction among the auditor, audit committee and management
- The extent of the audit engagement and other partners' involvement with the committee
- The relevance and completeness of the auditor's written and oral communications with the audit committee
- Whether the audit committee had established and communicated its expectations to the auditor and management

2.210 The reviewers found a large number of comprehensive, well-written reports to audit committees that demonstrated candid and comprehensive communications on numerous matters, including business risks, audit scope and approach, analyses and discussion of important financial statement issues, and waived adjustments. The communications required by SAS No. 61 were complete and well documented in almost every situation. In one area, however, namely, the requirement in SAS No. 61 to "determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates," the reviewers found that the relevant written communication very often was limited to the auditor simply indicating agreement with management's position.

2.211 The reviewers also found that certain topics considered important to audit committees often were not communicated. These included:

- The overall quality of annual financial reporting (not communicated on 20% of the engagements)
- Financial statement risks (15%)
- Estimates and judgments (12%)
- Internal control matters (13%)
- Risk of fraud (20%)
- Compliance with laws and regulations (19%)
- Interim financial reporting (21%)

2.212 Many situations were identified in which auditor–audit committee relationships were excellent and reflected timely, candid communications and an apparent sense of mutual trust. There is clear evidence, however, that the frequency of contact and substantive interaction between the auditor and the audit committee or its chair often can and should be improved.

2.213 The results of the Panel's survey, focus groups and interviews reflect very strong support for audit committees. Many participants commented, however, that the effectiveness of audit committees can and should be improved and communications and other relationships between audit committees and auditors need to be enhanced.

2.214 The reviewers sought to identify best practices regarding audit committees and specific opportunities to improve the committees' effectiveness. Essentially all of the best practices observed related to activities involving auditor–audit committee relationships and, more specifically, to the frequency of formal and informal contacts between the auditor and the committee or its chair. Not surprisingly, opportunities for improvement were focused largely on more auditor and audit committee contact, more frequent committee meetings, a higher level of committee activity and the committee's establishment of explicit expectations of the auditors.

2.215 The Panel supports the work of the Blue Ribbon Committee and the published responses of the following groups to which its report was addressed:

- Securities and Exchange Commission
- Auditing Standards Board
- New York Stock Exchange
- National Association of Securities Dealers

2.216 In addition, the Panel strongly supports more proactive audit committees and the development of stronger relationships between boards of directors (and their audit committees) and auditors that recognize that the auditors are ultimately accountable to the board of directors and the audit committee as representatives of the shareholders. The Panel also believes the development of explicit mutual expectations of the board and audit committee, management and the auditors is an essential initial step in the process.

Recommendations

To audit firms:

2.217 The Panel recommends that audit firms:

- Recognize the board of directors and audit committee, acting on behalf of the shareholders, as the parties to whom they are accountable and tailor their relationships and communications accordingly
- Make sure the audit committee's expectations are fully understood and that their communications with the committee are directly responsive to those expectations
- Reexamine firm guidance for reporting to audit committees and, if applicable, modify the guidance to promote candid discussions with the committee on:
 - Significant information system risks, including those related to any industry-specific regulations or issues
 - Qualitative observations about internal control

To the SECPS Peer Review Committee:

2.218 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Address the adequacy of firms' guidance on reporting to audit committees
- Include their findings in this area in their reports to the SECPS Peer Review Committee

To audit committees:

2.219 The Panel recommends that audit committees.⁶⁰

- Specify in their charters and reflect in their actions, as recommended by the Blue Ribbon Committee, “that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and where appropriate, replace the outside auditors (or to nominate the outside auditors to be proposed for shareholder approval in any proxy statement).”
- Develop a formal calendar of activities related to those areas of responsibility prescribed in the committee charter, including a meeting plan that is reviewed and agreed to by the entire board. The meeting plan should include communications between the committee chair or full committee and the auditor before the release of interim or year-end financial data. In addition, the Panel recommends a minimum of two face-to-face meetings during the year with the external auditor and at least one executive session with the internal and external auditors without management's presence.
- Take charge of their agenda and ensure, in particular, that it focuses on, among other matters, risks directly affecting the financial statements, key controls, interim financial information, policies and practices for management's communications with analysts, and the qualitative aspects of financial reporting
- Inquire about time pressures on the auditor, including pressures on the timing of audit procedures; the degree of management's cooperation with the auditor; and their potential effects on audit effectiveness
- Review the internal and external auditors' performance on an annual basis; exercise responsibility, as the external auditor's primary client, to assess the auditor's responsiveness to the committee's and board of directors' expectations; and be

⁶⁰ The Panel also has made recommendations to audit committees in “Communicating and Reporting on Internal Control” and “Auditing Estimates and Judgments” in this chapter, and in Chapters 3 and 5.

satisfied that the auditor is appropriately compensated for performing a thorough audit

- Require the auditor and management to advise the committee of the entity's plans to hire any of the audit firm's personnel into high-level positions, and the actions, if any, that the auditor and management intend to take to ensure that the auditor maintains independence

ESTABLISHING AUDITING STANDARDS

The GAAS Hierarchy

2.220 Various forms of guidance in addition to the SASs are provided to auditors by the AICPA, for the most part under the auspices of the ASB. For example, the ASB's Audit Issues Task Force (AITF) issues auditing interpretations on the application of the SASs. While these interpretations are reviewed by the ASB, they are not as authoritative as the SASs. In addition, the AICPA from time to time issues other forms of auditing guidance, such as audit and accounting guides, auditing practice releases and statements of position. These other forms of guidance often are related to specific industry issues or accounting pronouncements. Guidance also is provided by the AICPA through other communications (e.g., audit risk alerts), conferences and seminars (e.g., an annual conference on SEC developments) and other means. Textbooks, reference materials, and training materials and courses also are available to auditors from a wide variety of sources.

2.221 The guidance to auditors in the SASs alone is formidable. Yet many SASs lack imperatives that compel auditors to take definitive steps in specified circumstances. For example, in some cases an SAS may impose an imperative on an auditor by indicating what an auditor definitively "should" do, while in other cases an SAS might only indicate what an auditor "should consider," allowing significant latitude for the exercise of judgment based on the circumstances of the engagement and on the auditor's assessment of risk and materiality.

2.222 Furthermore, the SASs do not indicate in an organized fashion the vast array of other guidance discussed above that is available to auditors from the AICPA. In addition, some of that other auditing guidance is not readily accessible to auditors, although the AICPA has made efforts to improve retrieval of some of its literature via its website. As a result, auditors might feel less compelled to comply with auditing guidance that goes beyond the SASs and related AITF auditing interpretations. In summary, there is no formal GAAS "hierarchy" that establishes the authoritative status of auditing pronouncements.

Working Papers and Documentation

2.223 SAS No. 41, *Working Papers*, calls for auditors to prepare and maintain working papers, the form and content of which should be designed to meet the circumstances of a particular engagement. Working papers provide the principal support for the auditor's report, including the auditor's representation regarding observance of the standards of fieldwork. They also aid in

planning, conducting and supervising the audit. The SAS provides broad guidance on the nature of working papers and the documentation to be contained in them, indicating that they may be in the form of data stored on tapes, films or other media. SAS No. 41 observes, however, that there is no intention to preclude the auditor from supporting the audit report by other means in addition to working papers.

2.224 Beyond this broad standard relating to working papers, certain individual SASs require the auditor to document specified matters (e.g., SAS No. 82 requires documentation in the working papers of the auditor's fraud risk assessment and response). For the most part, however, the standards leave the extent of documentation to the judgment of the auditor. Individual firms' methodologies also specify certain documentation to meet their own needs.

2.225 The Panel believes that working papers and the documentation contained in them constitute an important quality control safeguard. Working paper documentation often is reviewed by persons other than the auditors who prepared the working papers. For example, auditors who are new to an engagement may review the prior year's working papers to gain an understanding of the work performed to aid in planning and performing the current audit. Supervisory personnel on an audit review the working papers prepared by assistants. Engagement partners or concurring partners may review all or selected working papers. Successor audit firms often review the predecessors' working papers. Internal inspection teams review engagement working papers as part of a firm's annual quality control review. Peer reviewers review the working papers on engagements selected for external peer review. Working papers also may be subject to review by other parties, for example, by representatives of a party to an acquisition, by regulators or by litigants' legal counsel.⁶¹ Access to auditors' working papers may be granted voluntarily by the audit firm (usually with client approval and some restrictions) or obtained by legal action, such as by subpoena.

2.226 The Panel is aware that the ASB adopted a strategic plan in 1997, *Horizons for the Auditing Standards Board: Strategic Initiatives Toward the Twenty-First Century*, which it updates annually. Among the actions taken by the ASB to implement its initiatives was establishing a task force on working paper documentation, and this task force is looking into some or all of the areas discussed in the Panel's recommendations. The Panel applauds the efforts by the ASB to reevaluate and update its strategic plan on an ongoing basis. The Panel believes that many of its recommendations to the ASB will affect the ASB's future priorities.

Recommendations

2.227 A number of the Panel's recommendations contained in this chapter urge the ASB to modify, amend or improve its standards by making them more specific and definitive. Other recommendations to the ASB suggest that clarification is needed to enhance audit effectiveness.

2.228 The Panel believes that auditing standards must serve to provide both reasonable and measurable benchmarks for performance by auditors. Standards need to be reasonable in that they should not force auditors to adhere to rules that do not take into account the myriad of

⁶¹ The Panel is aware that in certain cases regulatory requirements prescribe minimum guidelines for working paper content.

circumstances that may exist on audits. To serve as effective measures of the quality of performance, however, auditing standards need to provide clear, concise and definitive imperatives for auditors to follow.

2.229 The QPR disclosed that working paper documentation often was less than adequate from the reviewers' perspective, and some of the Panel's individual recommendations address documentation. The Panel also was informed that documentation deficiencies are common in many peer reviews, although the criteria for asserting such deficiencies are subjective.

2.230 The Panel understands that working papers and the documentation contained in them taken alone cannot be expected to support fully all of the activities constituting an audit, including the subtleties of judgments made throughout the audit process. No one expects the auditor's working papers to duplicate the entity's records or to contain unnecessary information. At the same time, reasonable documentation requirements can avoid over reliance on the recollections of those who performed the audit work – a potential consequence of reduced documentation as firms seek to streamline their audit methodologies and processes. The Panel believes that, within reasonable limits, the work of auditors needs to be documented appropriately.

2.231 It is with these points in mind that the Panel has developed the following recommendations.

To the Auditing Standards Board:

2.232 The Panel recommends that the ASB:

GAAS Hierarchy and Access to Guidance

- Definitively set forth the “hierarchy” of GAAS, including the authoritative status of existing AICPA guidance. The SASs should specify the guidance auditors should use in performing audits, whether that guidance is explicitly in the SASs or elsewhere.
- Ensure distribution and accessibility of ASB pronouncements to all AICPA members who provide attest services

Auditing Standards and Quality Control Standards Generally

- Review all the standards of fieldwork not addressed elsewhere in this report for the purpose of ensuring that they are sufficiently specific and definitive, either within the SASs or elsewhere in the GAAS hierarchy, to guide auditors in formulating their judgments and carrying out their work. While the ASB may decide to differentiate between auditing standards applicable to both non-public and public entities and those applicable only to public entities, in general the Panel discourages such practice, especially with standards of fieldwork, since investors might be confused by

the varying levels of audit quality that could result.⁶²

- Perform a similar review, in collaboration with the Peer Review Committee and QCIC, of the Statements on Quality Control Standards to ensure that they also are specific and definitive. (See the Panel’s recommendations to the SEC Practice Section and the ASB in the section “Enhancing Peer Reviews” in Chapter 6.)

Materiality

- Evaluate the guidance in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, on the auditor’s consideration of materiality in planning the audit and designing audit tests and on how materiality and risk assessments are related. Some of the findings and observations in this report that have resulted in recommendations to the ASB implicitly or explicitly raise questions about whether materiality guidelines used by auditors are too liberal or are not modified appropriately to reflect information obtained and conditions encountered in the course of the audit.

Materiality judgments are an integral part of the audit risk model and inevitably influence decisions on the areas of audit emphasis and the extent of audit testing, including sample sizes. Accordingly, as part of this effort, the ASB also should review its auditing standard on audit sampling, SAS No. 39, *Audit Sampling*. The ASB’s review should address whether more definitive guidance in the area of materiality – including the effects of materiality judgments on decisions about audit emphasis, the extent of audit testing and sample sizes related to specific objectives – might lead to more effective audits.⁶³

The ASB should request firms to share with it their guidance on materiality to assist it in its deliberations. The ASB also should consider appropriate research (possibly with the cooperation of firms, academic researchers and peer reviewers) on how the materiality concept is applied in practice.

The Panel believes that this effort likely will result in modifications to auditing standards, unless the ASB is satisfied on the basis of its research that the present guidance is sufficient to drive effective materiality judgments in planning the audit and designing audit tests.

⁶² Some auditing standards are designed to address matters unique to either public or non-public entities. For example, much of the guidance in SAS No. 71, *Interim Financial Information*, applies only to engagements to review interim financial information or statements of a public entity. The auditor communications called for by SAS No. 61, *Communications With Audit Committees*, are applicable only to audits of entities with audit committees (or the equivalent) and to audits of public entities. SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (as amended), is designed primarily for engagements related to registration statements filed with the SEC. Those SASs generally interpret the standards of reporting, not the general or fieldwork standards.

⁶³ The ASB also should consider the discussion of “*Materiality Issues*” under “Consideration of Exposure Draft Comments on the Forensic-type Phase” in Chapter 3.

Working Papers and Documentation

- Enhance SAS No. 41, *Working Papers*, to include criteria regarding the minimum documentation working papers should contain. The criteria for documentation to be included in working papers should be sufficiently specific to enable reviewers to understand the audit work performed, who performed and reviewed the work, and the nature of the audit evidence examined.
- Provide sufficient guidance in the quality control standards about working paper documentation to enable firms and peer reviewers to judge the quality of engagement performance (including the supervision of the work of assistants). The ASB should link the two sets of working paper standards to each other.
- Review all the fieldwork standards to ensure that there is definitive guidance within the SASs (or elsewhere in the GAAS hierarchy) on the type and extent of documentation that should be contained in the working papers. For example, the ASB should consider areas where specific documentation requirements similar to those contained in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, would likely enhance audit effectiveness, and it should amend or modify the SASs accordingly.

To the Public Oversight Board and the Auditing Standards Board:

2.233 The Panel recommends that, consistent with the POB's role of oversight over the ASB's agenda and processes, the POB review the ASB's prioritization, timetable and process for addressing the Panel's recommendations to it.⁶⁴ In so doing, the POB and the ASB should consider the following observations and insights offered by the Panel:

Priorities and Timetable

- This chapter and Chapter 3 contain many recommendations to the ASB. These recommendations have been organized along the same lines as the QPR, generally tracking the key elements of the audit risk model, but they have not been assigned priorities. The Panel has expressed the view that its recommendations to the ASB in Chapter 3 reasonably could be effective starting with audits of financial statements for periods commencing after December 31, 2001. Otherwise, it has not endeavored to prioritize its recommendations or set forth a timetable for their implementation. The Panel recognizes, however, that its recommendations in some audit areas are closely linked with those in other areas and require coordination when the ASB sets priorities and its agenda.⁶⁵ The POB should ensure that the recommendations are addressed in a timely and effective manner.

⁶⁴ The POB's proposed oversight role over the ASB is discussed in Chapter 6.

⁶⁵ The Panel is aware that the ASB already is addressing some of the Panel's recommendations and has set in motion a process for prioritizing and scheduling others.

ASB Due Process

- The Panel is aware that the ASB follows due process in formulating and promulgating GAAS and quality control standards, including subjecting its proposed pronouncements to public exposure and comment.⁶⁶ The ASB process weighs the relative benefits of its proposals with the attendant costs of implementing them. While respecting the importance of the ASB's due process, the Panel expresses confidence that its recommendations to the ASB, taken as a whole, are both reasonable and capable of implementation in a cost-effective manner.

Research and Innovation

- The Panel is aware that current or future research by the academic community and others may be relevant to matters addressed in its recommendations to the ASB.⁶⁷ Furthermore, the Panel acknowledges that the ASB will need to adapt GAAS and quality control standards to respond to new or evolving business conditions and demands on auditors. The Panel has developed its recommendations to meet both the current needs of investors for assurances on financial statements required under the present securities laws and the needs of investors in the reasonably foreseeable future. The Panel has not attempted, however, to predict the future “state-of-the-art” in accounting, the quantity or nature of financial and non-financial information that will be demanded by the marketplace, or how such information might be disseminated to and assimilated by investors in the longer term. (Chapter 8 contains the Panel's vision of some issues that pose a challenge in the years ahead.) Although the Panel believes that the ASB should consider carefully the results of research and the visions of accounting and auditing futurists, the ASB should not delay its timely pursuit of the Panel's recommendations until the research has been completed and evaluated.

⁶⁶ See “Standard-Setting Bodies” in Appendix C.

⁶⁷ See, for example, the JWG paper referred to in note 13, the “earnings management” study referred to in note 36 and the SAS No. 82 research referred to in note 3 in Chapter 3.