



Select Auditing Considerations for the 2014 Audit Cycle

This Alert is intended to remind member firms of certain auditing considerations that may be relevant for the 2014 audit cycle. The Alert identifies and discusses some of the more judgmental or complex audit areas, including those that have recently been the subject of attention and focus by regulators.

The CAQ encourages member firms to consider the topics addressed in this Alert in executing their 2014 audits. When considering these audit areas, auditors also should consider the elements of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (AS 12), and Auditing Standard No. 13 *The Auditor's Responses to the Risks of Material Misstatement* (AS 13), as auditing issues identified in these areas may also be indicative of misapplication of these risk assessment standards.

This Alert covers the following auditing considerations:

1. Revenue Recognition
2. Going Concern
3. Internal Control Over Financial Reporting
4. Auditing Accounting Estimates, Including Fair Value Measurements
5. Engagement Quality Review
6. Professional Skepticism
7. Related Parties and Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

While the Alert highlights certain areas for consideration, it should not be relied upon as definitive or all-inclusive, and should be read in conjunction with the applicable rules, standards and guidance in their entirety.

Revenue Recognition

Revenue typically is a significant account, often involving significant risks that warrant special audit consideration, and therefore often is a focus area in PCAOB inspections of registered firms. The PCAOB issued [Staff Audit Practice Alert No. 12, *Matters Related to Auditing Revenue in an Audit of Financial Statements*](#) (Practice Alert No. 12), in September 2014. In addition, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in May 2014 jointly adopted a converged accounting standard on revenue recognition (the new accounting standard). Practice Alert No. 12 discusses the application of certain requirements in PCAOB auditing standards that auditors should be mindful of when auditing revenue under current accounting guidance. These auditing matters likely will continue to have relevance to auditing revenue under the new accounting standard. Further, although the new accounting standard is not yet effective, the auditor should evaluate management's required disclosure of the impact the new accounting standard is likely to have on the financial statements, including evaluating the form, arrangement, and content of the disclosure. Below, we discuss some of the topics covered in Practice Alert No. 12. Please refer to Practice Alert No. 12 for the full details related to auditing revenue.



In designing the audit procedures to be performed, the auditor is required to (1) obtain more persuasive audit evidence the higher the auditor's assessment of risk; (2) take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement; and (3) in a financial statement audit, design tests of controls over revenue to obtain sufficient evidence to support the auditor's control risk assessments when the auditor relies on controls. Also, in an integrated audit, the auditor is required to design the tests of controls to simultaneously accomplish the objectives of both the financial statement audit and the audit of internal control over financial reporting.

Testing Revenue Recognition, Presentation and Disclosure

- Testing the recognition of revenue from contractual arrangements: To audit revenue, auditors should understand, among other things, the company's business, its different types of sales or service contracts, and its controls over revenue, including the company's development of accounting estimates for revenue. This also includes understanding the company's key products and services and business processes that affect revenue, including contractual terms by which sales are made, such as the key provisions of contractual arrangements and the extent to which contractual terms are standardized across the company's organization. The auditor also is required to evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the company's relevant industries. Examples of areas to focus on include production-type or construction-type contracts (e.g., perform sufficient procedures to test management's estimated costs to complete projects) and multiple-element arrangements (e.g., evaluate each of the deliverables to determine whether they represent separate units of accounting).

Further, revenue recognition often involves accounting estimates, such as estimates of future obligations under the terms of sale in the contract. If the accounting estimate is a fair value measurement, the auditor should apply the requirements of AU sec. 328, *Auditing Fair Value Measurements and Disclosures* (AU 328). For other estimates, the auditor should apply the requirements of AU sec. 342, *Auditing Accounting Estimates* (AU 342). These auditing standards address, among other things, the auditor's responsibilities with respect to evaluating the appropriateness of the company's methods and the reasonableness of management's assumptions used in the estimates and related disclosures, as well as the completeness and accuracy of company data used in the estimates.

- Evaluating the presentation of revenue – gross versus net revenue: When understanding the contractual terms of sales, it is important for the auditor to evaluate whether the company is the principal (i.e., the company is a seller that has the primary obligation to the customer) or agent (i.e., the company is a seller that does not have the primary obligation to the customer) in the transactions. That evaluation will determine whether revenue is properly presented as gross (when the company is acting as a principal) or net (when the company is acting as an agent).



- Testing whether revenue was recognized in the correct period: The risk of material misstatement involving the recognition of revenue in the incorrect period might be a risk of error (e.g., related to deficiencies in internal controls) or a risk of fraud (e.g., intentionally recognizing revenue prematurely), both resulting in improper revenue recognition. Audit procedures should be specifically designed to address the risk of material misstatement related to revenue recorded in the incorrect accounting period. Examples may include:
 - Performing cutoff procedures (e.g., testing sales transactions for a sufficient period before and after year-end to determine that the transactions were recorded in the proper period)
 - Obtaining evidence about whether the necessary delivery of goods had occurred (or service had been rendered)
 - Testing company-generated information, such as sales invoices or inventory records
- Evaluating whether the financial statements include the required disclosures regarding revenue: Auditors should perform procedures to identify, assess, and address risks of material misstatement of the financial statements including consideration of the risk of omitted, incomplete, or inaccurate disclosures. Qualitative considerations are especially important to the evaluation of misstatements in disclosures that are more narrative in nature. PCAOB auditing standards¹ describe the auditor's responsibilities for considering qualitative factors in the context of the auditor's consideration of materiality.

Other Aspects of Testing Revenue

- Responding to fraud risks associated with revenue: PCAOB auditing standards require the auditor to presume that there is a fraud risk involving improper revenue recognition and to evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks in the company being audited.² Performing procedures that are specifically responsive to the assessed fraud risks involves considering the ways that revenue could be intentionally misstated, how the fraud might be concealed, and designing audit procedures directed towards detecting intentional misstatements. When responding to fraud risks, it is important to design and perform procedures that seek reliable evidence that would be difficult for potential perpetrators to manipulate, such as evidence obtained directly from independent and knowledgeable sources outside the company. Additionally, incorporating an element of unpredictability in the audit procedures is important in responding to fraud risks. Unpredictable audit procedures make it more difficult for individuals looking to perpetrate a fraud to anticipate, and therefore, more difficult to conceal an intentional misstatement. Some examples of unpredictable audit procedures include:
 - Varying the timing of the audit procedures
 - Selecting items for testing that have lower amounts or are otherwise outside customary selection parameters
 - Performing audit procedures on an unannounced basis

¹ For example, see paragraph 24 and Appendix B of Auditing Standard No. 14, *Evaluating Audit Results*.

² See paragraph 68, AS 12.



- Applying audit sampling procedures to test revenue: AU sec. 350, *Audit Sampling* (AU 350), establishes requirements for planning and performing audit sampling procedures, and evaluating the results of such procedures. Examples of areas to focus on when applying audit sampling procedures to test revenue include:
 - Considering the tolerable misstatement for the population, the allowable risk of incorrect acceptance and the characteristics of the population when determining sample sizes
 - Choosing a representative sample
 - Testing sample items, including assessing the impact of not being able to apply the planned audit procedures because supporting documentation may be missing
 - Selecting specific items not involving sampling
- Performing substantive analytical procedures to test revenue: When properly applied under appropriate conditions, substantive analytical procedures can identify a potential material misstatement. Under PCAOB standards, substantive analytical procedures alone are not sufficient to respond to significant risks, including fraud risks; therefore, tests of details also are needed in those situations.³ When designing substantive analytical procedures, the auditor should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments may have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.

To achieve the necessary level of assurance from substantive analytical procedures, the auditor should design and perform procedures that appropriately take into account, among other things:

- The nature of the assertion
- The plausibility and predictability of the relationship
- The availability and reliability of the data used to develop the expectation
- The precision of the expectation
- The threshold for investigation of differences

The *plausibility and predictability* of relationships is a critical factor in developing a properly designed and performed substantive analytical procedure. For example, relationships typically are less predictable when there are less stable environments or when amounts are determined from complex processes, subjective judgments, or transactions subject to management discretion. On the other hand, relationships might be more predictable if they are based on established relationships, such as, cash flows based on contract terms (when nonpayment risk is low) and verifiable rate-volume determinations.

³ See paragraphs 11 and 13, AS 13.



The auditor should assess the *reliability of data* used by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over the financial information or perform other procedures to support the completeness and accuracy of the underlying information.

The *precision* of the expectation should be set to an appropriate level in order to provide the desired level of assurance that differences that may be potential material misstatements – individually or when aggregated with other misstatements – would be identified. For example, expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons.

Further, the *threshold for investigation* (i.e., the amount of difference from the expectation that can be accepted without further investigation) is influenced primarily by materiality. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.

Finally, performance of substantive analytical procedures involves making the comparisons of relationships as designed, including evaluating significant unexpected differences. This should include obtaining sufficient evidence to corroborate management responses. When an auditor cannot obtain an explanation for the difference, the auditor is required to perform additional audit procedures in response to significant unexpected differences.

- Testing revenue in companies with multiple locations: When a company has operations in multiple locations or has multiple business units that generate or process revenue, the auditor is required to determine the extent to which audit procedures should be performed at selected locations or business units in gathering sufficient appropriate audit evidence. Auditing Standard No. 9, *Audit Planning* (AS 9), includes the following factors that are relevant to the assessment of the risk of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures to be performed:⁴
 - The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, for example, significant transactions executed at the location or business unit that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor’s understanding of the company and its environment;
 - The materiality of the location or business unit;
 - The specific risks associated with the location or business unit that present a reasonable possibility of material misstatement;
 - Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units, such that, in combination, they present a reasonable possibility of material misstatement;

⁴ See paragraph 12, AS 9.



- The degree of centralization of records or information processing;
- The effectiveness of the control environment; and
- The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit

Auditors are encouraged to read Practice Alert No. 12 for a more thorough examination of each of the above topics.

Going Concern

The FASB in August 2014 issued ASU 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern* (the ASU), which provides guidance on determining when and how to disclose going concern uncertainties in the financial statements. The ASU requires management to perform an assessment every reporting period (including interim periods) to determine whether there is *substantial doubt* about a company’s ability to continue as a going concern and to provide related footnote disclosures.

The ASU also defines that *substantial doubt* exists when relevant conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or available to be issued). The ASU applies to all entities and is effective for annual periods ending after December 15, 2016, and interim periods thereafter, with early adoption permitted.

In light of the ASU, the PCAOB issued [Staff Audit Practice Alert No. 13](#), *Matters Related to the Auditor’s Consideration of a Company’s Ability to Continue as a Going Concern*, in September 2014 to remind auditors that despite the issuance of the ASU, the auditor’s requirements under existing PCAOB Standard, AU sec. 341, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern* (AU 341) have not changed and continue to be in effect. Auditors should continue to follow the requirements of AU 341 when evaluating a company’s ability to continue as a going concern. Among other things, AU 341 requires the auditor to modify the auditor’s report by including an explanatory paragraph when substantial doubt exists about the company’s ability to continue as a going concern. However, under AU 341, the auditor’s evaluation of whether substantial doubt exists is qualitative based on the relevant events and conditions and other considerations.

Therefore, a company’s determination that no disclosure would be required under the ASU is not conclusive as to whether an explanatory paragraph is required under AU 341. Auditors should continue to look to the existing requirements in AU 341 when evaluating whether substantial doubt regarding the company’s ability to continue as a going concern exists for purposes of determining whether the auditor’s report should be modified to include an explanatory paragraph.

Internal Control Over Financial Reporting

Deficiencies related to internal control over financial reporting continue to be cited in PCAOB inspection reports. Many of the findings identified in the 2014 inspection cycle are similar to those highlighted by the PCAOB in its [Staff Audit Practice Alert No. 11](#), *Considerations for Audits of Internal Control Over*



Financial Reporting, (Practice Alert No. 11). Issued in October 2013, Practice Alert No. 11 focused on seven areas related to the audit of internal control over financial reporting, which are summarized below.

- Risk assessment and the audit of internal control over financial reporting: Risk assessment is a key element of the top-down approach, and it underlies the entire audit process in the audit of internal control over financial reporting. Understanding the flow of transactions and identifying the risks of material misstatement – including the types of potential misstatements that can occur and the likely sources of those potential misstatements – is necessary for the auditor to select appropriate controls to test and to evaluate whether those controls adequately address the risks.
- Selecting controls to test: The auditor should select controls that, individually or in combination, are intended to address the identified risks of material misstatement. This includes selecting controls that address the relevant assertions and the components of the account or disclosure with differing risks. Some risks, including those related to complex processes or subjective estimates, may require a combination of controls to prevent or detect misstatements. Also, selecting controls to test applies to both routine and infrequent processes, such as analysis of whether long-lived assets are impaired, as well as to nonrecurring transactions, such as a material business combination.

Additionally, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (AS 5), requires that a control must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control is effective because no misstatements were detected by substantive procedures. In addition, when performing tests of controls over transactions concurrently with substantive tests of those transactions (i.e., performing dual-purpose testing), the auditor's substantive testing and tests of controls should be sufficient to meet the objectives of both tests.

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

Some management review controls operate at a level of precision that would adequately prevent or detect material misstatements on a timely basis. Others might not operate with the necessary level of precision, but might be effective in combination with other controls in addressing the assessed risk of material misstatement for the relevant assertions of significant accounts. Factors that can affect the level of precision include the following:

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



In addition to assessing precision, an auditor is required to evaluate whether the design of management review controls is capable of preventing or detecting potential material misstatements, which generally involves obtaining an understanding of and evaluating the following:

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

Testing operating effectiveness typically involves obtaining and evaluating evidence about the steps performed to identify and investigate significant differences and conclusions reached in the reviewer's investigation, including whether potential misstatements were appropriately investigated and whether corrective actions were taken as needed. The auditor also should take into account other relevant evidence obtained in the audit when evaluating the effectiveness of a control, such as identified misstatements that were not prevented or detected by the control.

- Information technology (IT) considerations, including system-generated data and reports: PCAOB auditing standards require the auditor to obtain an understanding of the company's IT systems relevant to financial reporting and take IT considerations into account in assessing the risks of material misstatement.⁵ This includes obtaining an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls (ITGCs) that are important to the effective operation of the automated controls. The auditor also should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. If a control selected uses system-generated data or reports, the effectiveness of the control depends in part on the controls over the accuracy and completeness of the system-generated data or reports. In that situation, assessing the effectiveness of the selected control would involve testing both the selected control and the ITGCs and IT-dependent controls over the system-generated data and reports. The existence of control deficiencies in ITGCs may impact the auditor's ability to conclude on the effectiveness of an IT-dependent control, as well as affect the nature and extent of testing over other controls that rely on such data and reports.
- Roll-forward of controls tested at an interim date: Although the auditor expresses an opinion on internal control over financial reporting as of a specific date, auditors may decide to test some important controls during the year. When controls are tested at an interim date, PCAOB auditing standards require auditors to perform roll-forward procedures to update the results of interim testing through the as of date of the report. The amount of evidence needed from roll-forward procedures depends on the risks of the control, the results of and sufficiency of evidence obtained from interim testing, the length of the roll-forward period, and the possibility that there were significant changes in internal control over financial reporting since interim. Inquiry might be a sufficient roll-forward

⁵ See AS 12.



procedure when evaluation of the preceding items indicates a low risk that the controls are no longer effective during the roll-forward period. In other situations (e.g., when the control is complex, subjective or otherwise higher risk; the control was not tested extensively at the interim date or there were exceptions noted in the interim testing; the roll-forward period was significant or there were significant changes during it), inquiry alone may not be sufficient and more persuasive evidence should be obtained based on the specific controls tested and their associated risks.

- Using the work of others: PCAOB auditing standards allow the auditor to use the work of others (e.g., internal audit) as evidence of the effectiveness of selected controls,⁶ and AS 5 requires auditors to evaluate the extent to which the work of others will be used. AS 5 provides that the extent to which the work of others can be used depends on the risk associated with the control being tested and the competence and objectivity of the persons whose work the auditor plans to use. The risk associated with the control is the risk that a control might not be effective and, if not effective, that a material weakness could result. As the risk associated with the control increases, the need for the auditor to perform his or her own testing of the control increases. In higher risk areas (e.g., testing complex controls, controls that address fraud risks or that require significant judgment), use of the work of others should be limited, if used at all, while the work of competent and objective persons could be used more extensively in lower risk areas. When the auditor uses the work of others, the auditor also should test and evaluate that work, including evaluating the quality and effectiveness of the others' work. The necessary extent of testing of that work depends on the risk associated with the control and the competence and objectivity of the others. In addition, the auditor should re-evaluate during its testing and review of the work of others to determine whether the quality of the work is consistent with the auditor's initial assessment of competence and objectivity.
- Evaluating identified control deficiencies: In addition to control deficiencies identified during the audit of internal control over financial reporting, control deficiencies might be identified during the audit of the financial statements. AS 5 requires auditors to evaluate the effect of misstatements detected by substantive procedures on the effectiveness of internal control and to evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination with other deficiencies, are material weaknesses. For example, an IT control might not be intended to prevent or detect misstatements by itself but an IT control deficiency might impair the effectiveness of important IT-dependent controls across multiple accounts. Evaluating whether a control deficiency or a combination of control deficiencies results in a material weakness requires professional judgment and a careful analysis of the evidence obtained, including consideration of the likelihood and potential magnitude of misstatement arising from the control deficiencies. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

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

⁶ See AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.



Auditing Accounting Estimates, Including Fair Value Measurements⁷

When auditing accounting estimates, including fair value measurements, the auditor is responsible for evaluating how accounting estimates have been developed; assessing the reasonableness of accounting estimates made by management in the circumstances; and assessing whether they are presented in conformity with applicable accounting principles and are appropriately disclosed. Examples of management estimates may include those related to purchase price allocations, impairment assessments, the fair value of investments, allowances for doubtful accounts and loan losses, and uncertain tax positions.

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

- Evaluate the reliability of underlying data used by management in developing the estimate by testing the data or the controls over the data;
- Evaluate whether the accounting estimate was prepared by qualified personnel, and whether management has engaged an external specialist⁸ to assist in the development of the accounting estimate, if necessary;
- Consider whether there has been adequate review and approval of the estimates including, for example, sources of relevant factors, the development of assumptions and the level of precision of the review;
- Compare prior accounting estimates with subsequent results to assess the reliability of the process used by management to develop estimates; and
- Assess management's consideration of whether the resulting accounting estimate is consistent with the operational plans of the company.

For the financial statement audit, in evaluating the reasonableness of management's estimates, the auditor should obtain an understanding of how management developed the estimate and, based upon that understanding, use one or a combination of the following approaches:⁹

- Review and test the process used by management to develop the estimate.
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- Review subsequent events or transactions occurring prior to the date of the auditor's report.

⁷ See AU 342 and AU 328 for additional guidance related to auditing accounting estimates and fair value measurements, respectively.

⁸ See AU 336, *Using the Work of Specialist*, for additional guidance related to the auditor's use of the work of a specialist in performing an audit.

⁹ See paragraph 10, AU 342.



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

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

Additionally, the auditor generally should consider historical experience of the company in making past estimates as well as the auditor's experience in the industry. However, changes in facts, circumstances, or company's procedures may cause factors different from those considered in the past to become significant to the accounting estimate. After auditing each accounting estimate individually, the auditor should consider the accounting estimates in the aggregate in order to evaluate whether the aggregate difference between the estimates best supported by the audit evidence and the individually reasonable estimates included in the financial statements indicate a possible bias on the part of the company's management.

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

Auditing a company's fair value measurements includes verifying that the company has made adequate disclosures in conformity with GAAP.¹⁰ If disclosures are omitted due to the impracticality to determine fair values, the auditor should evaluate the adequacy of the required disclosures in these circumstances. If required GAAP disclosures are not made, the auditor should evaluate whether the financial statements are materially misstated and assess the impact on internal control over financial reporting.

Engagement Quality Review

Recent inspection cycles identified findings around auditors' execution of procedures in accordance with Auditing Standard No. 7, *Engagement Quality Review* (AS 7), that are similar to those highlighted in a 2013 PCAOB public report.¹¹ AS 7 requires the engagement quality reviewer to perform specific procedures to evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the audit report. The specific procedures the engagement quality reviewer should perform include:

- Evaluating the significant judgments that relate to engagement planning, including consideration of the firm's client acceptance and retention process, the company's business, and the judgments made about materiality including the effect of those judgments on the engagement strategy.
- Evaluating the engagement team's identification of significant risks, including fraud risks, and audit responses to those risks.

¹⁰ See paragraph 3, AU 328.

¹¹ [PCAOB Release No. 2013-011](#), Observations Related to the Implementation of the Auditing Standard on Engagement Quality Review.



- Evaluating the significant judgments made about (1) the materiality and disposition of corrected and uncorrected misstatements and (2) the severity and disposition of identified control deficiencies.
- Reviewing the engagement team’s evaluation of the audit firm’s independence.
- Reviewing the engagement completion document, confirming with the engagement partner that there are no significant unresolved matters.
- Reviewing the financial statements and related reports (e.g., management’s report on internal control).
- Reading the other information in documents containing the financial statements to be filed with the Securities and Exchange Commission (SEC), and evaluating whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.
- Based on these procedures, the engagement quality reviewer also should evaluate if appropriate consultations have occurred on difficult or contentious matters and, if so, whether the conclusions relating to such matters have been appropriately documented. Further, the engagement quality reviewer should evaluate whether appropriate matters have been communicated or identified for communication to the audit committee, management, and other parties.

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

Professional Skepticism

The auditor is required to plan and perform his or her work with due professional care, which requires the auditor to exercise professional skepticism.¹² PCAOB auditing standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence.¹³ As a result, professional skepticism should be exercised throughout the audit process, including in those areas of the audit that involve significant management judgments, transactions that are outside the normal course of business, and as it relates to the auditor’s consideration of fraud in an audit. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. For example, when applying professional skepticism in response to identified fraud risks, an auditor should (a) modify the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtain sufficient appropriate evidence (e.g., third-party confirmation, examination of documentation from independent sources).

The engagement partner is responsible for setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge

¹² To remind auditors of this requirement, the PCAOB issued in December 2012 [Staff Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits](#), certain aspects of which are discussed within the Alert.

¹³ See paragraph 7, AU 230, *Due Professional Care in the Performance of Work*.



management representations. The engagement partner and other senior engagement team members also should be involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention, such as unusual matters or inconsistencies in audit evidence, are identified and addressed appropriately.

Professional skepticism involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence (rather than merely obtaining the most readily available evidence to corroborate management's assertions), and critically evaluating all evidence regardless of whether it corroborates or contradicts management's assertions. Refer to the CAQ's [Professional Judgment Resource](#), which is designed to provide auditors with an example decision-making process intended to facilitate important auditing and accounting judgments in a professionally skeptical manner.

Related Parties and Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

The PCAOB adopted (and the SEC subsequently approved) [Auditing Standard No.18, Related Parties](#) (AS 18) and Amendments to Other Auditing Standards, in June 2014 to strengthen auditor performance requirements in three critical areas of the audit: (1) related party transactions, (2) significant unusual transactions, and (3) a company's financial relationships and transactions with its executive officers. AS 18 and the amendments to other auditing standards are effective for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within these fiscal years. AS 18 supersedes the PCAOB's interim auditing standard, AU sec. 334, *Related Parties*.

Related Party Transactions

Among other things, AS 18 requires the auditor to:

- Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties, including obtaining an understanding of the nature of the relationships and of the terms and business purposes (or the lack thereof) of transactions involving related parties. These new procedures are performed in conjunction with the auditor's risk assessment procedures in AS 12.
- Evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties. In making that evaluation, the auditor performs procedures to test the accuracy and completeness of management's identification, taking into account information gathered during the audit. If the auditor identifies information that indicates that undisclosed relationships and transactions with a related party might exist, the auditor performs procedures necessary to determine whether undisclosed relationships or transactions with related parties in fact exist.
- Perform specific procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists.
- Perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk.



- Communicate to the audit committee the auditor's evaluation of the company's (a) identification of, (b) accounting for, and (c) disclosure of its relationships and transactions with related parties, and other related significant matters arising from the audit.

Significant Unusual Transactions

The amendments related to significant unusual transactions principally revise AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and require the auditor, among other things, to:

- Perform specific procedures to identify significant unusual transactions.
- Perform specific procedures to obtain an understanding of and evaluate the business purpose (or the lack thereof) of identified significant unusual transactions.
- Consider additional factors in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Financial Relationships and Transactions with Executive Officers

The amendments related to a company's financial relationships and transactions with its executive officers, such as executive officer compensation, require the auditor, as part of the audit risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. These procedures are intended to heighten the auditor's attention to incentives or pressures for the company to achieve a particular financial position or operating results, recognizing the key role that a company's executive officers may play in the company's accounting decisions or in a company's financial reporting. However, the amendments do not require the auditor to make any determination regarding the reasonableness of compensation arrangements or make recommendations regarding compensation arrangements.