
STANDING ADVISORY GROUP MEETING

YEAR-END AUDIT RISK AND FINANCIAL REPORTING ISSUES

NOVEMBER 9-10, 2011

Introduction

At the October 2008 meeting of the Standing Advisory Group ("SAG"), members of the SAG were asked to provide their views on how the then current economic environment would affect the risk of material misstatement of financial statements, and, as a result, auditors' upcoming audits. SAG members also were asked whether the PCAOB should issue additional guidance to assist auditors in their upcoming audits. Following these discussions, in December 2008, the PCAOB issued Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* ("Practice Alert No. 3"), which is attached to this briefing paper.

Since the issuance of Practice Alert No. 3, key economic indicators have been slower to recover than many had originally anticipated, and concerns continue to be expressed over global economic conditions.^{1/} For example, on September 15, 2011, Christine Lagarde, IMF Managing Director, said "[o]verall, global growth is continuing, but slowing down. The advanced countries in particular are facing an anemic and bumpy recovery, with unacceptably high unemployment. The euro area debt crisis has worsened. Financial strains are rising. And again—without collective, bold, action, there is a real risk that the

^{1/} For example, in August 2011, the Congressional Budget Office reported that "[a]lthough economic output began to expand again two years ago, the pace of the recovery has been slow, and the economy remains in a severe slump." (Congress of the United States Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2011).

This paper was developed by the staff of the Office of the Chief Auditor as of November 3, 2011 to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

major economies slip back instead of moving forward.”^{2/} Ms. Lagarde went on to state that “[a] key short-run issue in advanced countries is that balance sheet pressures are knocking the wind out of the recovery. There is still too much debt in the system. Uncertainty hovers over sovereigns across the advanced economies, banks in Europe, and households in the United States.”^{3/}

These economic developments have led to recent PCAOB staff outreach with various external parties, including auditors, investors, and other regulators to discuss the ongoing relevance of the financial reporting areas included in Practice Alert No. 3. Those discussions have also included whether there are additional areas that potentially have implications for upcoming audits of financial statements and internal control over financial reporting.

In light of these ongoing concerns, the staff is considering issuing a practice alert to address these issues and the risks stemming from the current global economy, and to update certain audit considerations in Practice Alert No. 3 for changes to PCAOB standards that became effective after it was issued.

At the November 2011 SAG meeting, SAG members will be asked to provide their views on whether the topics included in Practice Alert No. 3 are still relevant to upcoming audits. In addition, the staff will seek SAG members’ views on whether there are other auditing and financial reporting issues arising from the current economic environment that a new staff practice alert should address.

Considerations for Upcoming Audits

Practice Alert No. 3 focused on matters relating to the 2008 economic environment that might affect audit risk and the auditor’s responsibilities under PCAOB standards for addressing those risks. The matters in the alert include overall audit considerations, auditing fair value measurements and accounting estimates, the auditor’s consideration of a company’s ability to continue as a going concern, and auditing the adequacy of financial statement disclosures. Additionally, Practice Alert No. 3 outlined additional audit considerations for certain financial reporting areas.

^{2/} The full text of Ms. Lagarde’s speech is available at <http://www.imf.org/external/np/speeches/2011/091511.htm>.

^{3/} In September 2011, the International Monetary Fund ("IMF") reduced its estimate of 2012 global growth from 4.5%, which was provided in June 2011, to 4% and, at the same time, reduced its 2012 growth forecast for U.S. growth from 2.7% to 1.8%.

Many of the matters, such as fair values, estimates, going concern, and disclosures, discussed in Practice Alert No. 3 continue to have relevance. For example, fair value measurements and estimates were the subject of certain audit deficiencies noted in the Board's *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* which was issued in September 2010 and which included aspects of the 2009 inspection cycle.^{4/} However many of the auditing standards referenced in the Alert regarding the auditor's assessment of risk were superseded in December 2010, when the Board adopted and the U.S. Securities and Exchange Commission approved a suite of eight new auditing standards ("risk assessment standards"). These standards, which enhance the effectiveness of the auditor's assessment of and response to risk of material misstatement in an audit,^{5/} became effective for audits of fiscal periods beginning on or after December 15, 2010. Highlighting in a staff audit practice alert certain requirements in the new risk assessment standards that are particularly relevant to audits in times of economic uncertainty may be helpful to auditors and improve audit quality.

Performance of Risk Assessment Procedures and Evaluating the Ongoing Appropriateness of Risk Assessment

As compared to the Board's interim standards, the risk assessment standards establish enhanced requirements pertaining to the performance of risk assessment procedures. For example, an auditor should obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement.^{6/} The risk assessment standards require the auditor's assessment of the risks of material misstatement to continue

^{4/} See *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* available at: <http://pcaobus.org/Inspections/Pages/PublicReports.aspx>.

^{5/} Auditing Standards Nos. 8-15 were adopted by the Board on August 5, 2010. See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, available at: http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf.

^{6/} See paragraphs 7-17 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

throughout the audit.^{7/} Significant changes in industry or market conditions near year end, including, for example, downward revisions in forecasts of gross domestic product growth, might provide audit evidence that contradicts the evidence on which the auditor originally based his or her risk assessments regarding the valuation of assets. In such cases the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessment.^{8/}

Significant Risks

The risk assessment standards provide additional factors relevant to identifying significant risks.^{9/} A significant risk is a risk that requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.^{10/} Factors that should be evaluated in determining which risks are significant risks include, among other things:

- Whether the risk is related to recent significant economic developments, and
- The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.^{11/}

Significant risks might arise from changing economic conditions, including, for example, risks of impairment related to direct or indirect exposure to downgraded sovereign debt or exchange rate volatility, especially if the risks result in pressure for management to meet certain financial targets or create a higher level of complexity. The risk assessment standards require the auditor to perform

^{7/} See paragraph 74 of Auditing Standard No. 12.

^{8/} See paragraph 74 of Auditing Standard No. 12 and paragraph 46 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

^{9/} See paragraph 71 of Auditing Standard No. 12.

^{10/} Paragraphs 70 of Auditing Standard No. 12.

^{11/} Paragraph 71 of Auditing Standard No. 12.

substantive procedures, including tests of details, that are specifically responsive to the assessed risks.^{12/}

Financial Statement Disclosures

As discussed with the SAG earlier this year, the risk assessment standards also recognize the importance of financial statement disclosures by directing auditor attention to them throughout the audit process.^{13/} For example, the risk assessment standards require the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.^{14/} The risk assessment standards also require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional;^{15/} and to identify and test significant disclosures.^{16/} In the current economic environment risks may increase regarding the adequacy of disclosures, including, for example, the adequacy of disclosures regarding loss contingencies, risks and uncertainties, fair value measurements and triggering events necessitating the evaluation of certain assets for impairment.

^{12/} Paragraph 11 of Auditing Standard No. 13.

^{13/} See Standing Advisory Group March 23, 2011 briefing paper "Auditing Financial Statement Disclosures" available at: http://pcaobus.org/News/Events/Pages/03232011_SAGMeeting.aspx.

^{14/} Paragraph 12 of Auditing Standard No. 12.

^{15/} See, for example, paragraphs 49, 52 and 67 of Auditing Standard No. 12.

^{16/} See, for example, paragraphs 59-64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

Discussion Questions:

1. Do the considerations described in Practice Alert No. 3 continue to present specific audit challenges in the current economic environment? If so, which of these considerations are likely to be most significant?
2. What additional risks or auditing and accounting issues relating to the current economic environment are likely to arise in upcoming audits? Which of these risks and issues are likely to be most significant?
3. Are there certain fair values, estimates, or disclosures which may pose particular challenges in the current economic environment?

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