How to audit high-risk areas

With the right focus and training, practitioners can master the most complex and challenging areas of audits.

By Maria L. Murphy, CPA
External auditors are under tremendous pressure to plan and execute audits in a constantly changing environment.

New accounting and auditing standards, such as the converged revenue recognition standard that FASB and the International Accounting Standards Board issued and are now revising, create a constant need for auditors to update the way they do their work. Meanwhile, technology and globalization are changing the way businesses operate, and regulators and investors are increasing their scrutiny of auditors and the companies that they audit.

Amid all this change, certain areas of audits have emerged as particularly challenging and complex. Auditing revenue recognition, internal control over financial reporting (ICFR), and accounting estimates, including fair value measurements, have been identified by the PCAOB, the Center for Audit Quality (CAQ), and the International Forum of Independent Audit Regulators as areas of high risk or high deficiencies in audits. In the United States, evolving standards related to going concern have made this a challenging area as well.

Getting it right in these areas is a crucial component of a high-quality audit. But that may not be the first question. PCAOB board member Jay Hanson, CPA, said a more fundamental question is, “What does ‘right’ look like?”

“Regulators like the PCAOB are charged with inspecting for compliance and reporting on deficiencies,” Hanson said. “But we do see audit engagements that are well done at the same inspected firms where deficiencies are found. A different way of thinking would be for inspection reports to include observations about what was done right on engagements.”

In the past couple of years, Hanson said, the board has been trying to shift the discussion from one that includes the root causes of deficiencies to one that also identifies the root causes of successful audits.

“The successful audits have the right auditor attitudes, engagement team involvement, resources available, and skill sets applied at the right place and time,” he said.

PwC LLP’s Len Combs, CPA, said auditors can learn from inspection findings, PCAOB staff bulletins, and CAQ alerts because they provide areas of common findings and challenges for auditors. He said areas such as revenue recognition, going concern, ICFR, and accounting estimates/fair value are challenging by nature.

“They often require auditors to evaluate not only what happened in the past but also management’s expectation of what may happen in the future,” said Combs, the U.S. chief auditor and leader of auditing services, methods, and tools for PwC.

The CAQ, which is affiliated with the AICPA, issued an audit risk alert for the 2014 audit cycle that included these and other areas that can be challenging for auditors. The alert is available at tinyurl.com/l2vq4n3.

Below are examples of some of the more challenging aspects of auditing, along with suggestions on how to audit these areas more effectively.

**REVENUE RECOGNITION**

Because revenue is often a significant account involving significant risks, auditors must understand the company’s business and processes, obtain appropriate audit evidence, test controls over revenue, and assess potential misstatements. Auditors must understand the company’s sources of revenue and types of contracts and evaluate whether the selection and application of accounting principles for revenue recognition are appropriate. Significant accounting estimates often are involved. Auditing revenue includes testing whether revenue was recognized in the correct period, performing procedures to address fraud risk, and evaluating related financial statement disclosures.

Hanson suggested that effective auditing of revenue today requires a shift away from the approach used by many auditors in the past, which focused on the balance sheet with a more limited analytical review of the income statement.

“Firms are on a journey towards better execution of effective substantive analytical procedures,” he said. “Auditors need not only to determine that there was a reasonable change in revenue period over period, but also to understand the reason for the relationships and correlations of the numbers. They need to set expectations at a granular enough level in order to detect material misstatements.”

The PCAOB in September 2014 issued Staff Audit Practice Alert No. 12, Matters Related to Auditing Revenue in an Audit of Financial Statements, to assist auditors in this difficult area. Hanson also points out that auditors must understand the specific risks of material misstatements and design procedures around the company’s business process, including how its customers, contracts, and products affect revenue recognition. He suggested that when more senior members of the audit team are involved in understanding the business and related processes, the audit work is more effective.

Combs indicated that not all areas of revenue recognition are high-risk and complex for all companies. Companies producing a large number of homogeneous products, which can be sold to a number of different customers, may have less complexity around revenue recognition. But he agrees that this area could be one...
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with high estimation uncertainty and fraud implications. Survey statistics show that revenue recognition is a high-risk area for financial statement fraud. Twenty-three percent of respondents to The 2014 AICPA Survey on International Trends in Forensic and Valuation Services said that revenue recognition would be the most prevalent financial statement misrepresentation issue in the next two to five years.

Combs said that although the new, converged revenue recognition standard should not change the nature of how to audit revenue estimates, he expects it will introduce more situations where complex estimates are necessary in accounting for revenue that potentially will result in higher assessed risks and require additional audit attention.

GOING CONCERN
FASB issued in 2014 Accounting Standards Update (ASU) No. 2014-15, Presentation of Financial Statements—Going Concern (Subtopic 205-40). The amendments create a new requirement for management to perform an assessment every reporting period of whether there is substantial doubt about a company’s ability to continue as a going concern and to provide related disclosures of going concern uncertainties in financial statements. FASB defined “substantial doubt” for purposes of the accounting disclosures, but that definition does not apply to the requirements under the auditing standards. Auditors must assess management’s going concern evaluation and required disclosures to evaluate whether the financial statements are fairly presented in accordance with GAAP. The audit requirements for evaluating going concern under existing auditing standards (AU Section 341), for purposes of determining whether to modify the auditor’s report to include an explanatory paragraph about going concern, have not been changed by the ASU’s issuance.

Combs believes this area can be challenging for auditors because they often must evaluate the company’s ability to generate future cash flows, which includes management assumptions about the future.

“Specialists may need to be involved in assessing future cash flows, sensitivities, and assumptions, including assessing evidence which is contrary to management’s projections,” he said. “The complexity and risk vary based on the company’s environment and the stability and history of the business.”

Hanson said there have been relatively few inspection findings based on the current auditing standard on going concern but noted that the PCAOB has heard from investors that going concern reporting under current standards may not be meeting their needs. He encourages auditors to follow the standard and to think about whether investors would want to know what the auditors know about a company’s ability to continue as a going concern. 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 and is developing a staff consultation paper on whether to change the auditing standard, including the form of the audit report and how to test management’s assessment of going concern under the new ASU. Hanson encouraged auditors and others to send their comments on the paper to the PCAOB staff after it is issued.

INTERNAL CONTROL
Deficiencies in audits of ICFR are frequently noted in PCAOB inspections, and the PCAOB issued Staff Audit Practice Alert No. 11, Considerations for Audits of Internal Control Over Financial Reporting, in October 2013 focusing on this audit area. Auditors must understand the flow of transactions and identify the risks of material misstatement to select appropriate controls for testing that address the risks. Selecting controls to test applies to both routine and infrequent processes. Management review controls intended to prevent and detect misstatements should also be evaluated and tested for design and operation. Auditors must understand information technology related to financial reporting, including manual and automated controls, IT general controls, specific risks resulting from IT, and controls over accuracy and completeness of system-generated data and reports. Misstatements detected during substantive procedures must be evaluated to determine whether the internal controls are deficient and whether the deficiencies are material weaknesses.

Hanson said that the Sarbanes-Oxley Act of 2002, with its requirement for auditors to report on the effectiveness of internal controls, was one of the most significant changes to audits since the securities laws were enacted in 1933 and 1934. He added that it took some time for firms to adjust to the requirements of Auditing
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Spurred by inspection findings, the PCAOB has engaged its Standing Advisory Group in discussions on accounting estimates and fair value measurement in August 2014 and a staff consultation paper on auditing accounting estimates. The PCAOB also issued a statement that may not have the internal resources and may have to engage third-party specialists. The PCAOB’s small business forums include this as a topic area and provide training and resources. The PCAOB also issued a staff consultation paper on auditing accounting estimates and fair value measurement in August 2014 and has engaged its Standing Advisory Group in discussions on this complex topic.

These challenging audit areas are likely to continue to be subject to evolving guidance and regulatory scrutiny. With the proper focus and training, though, practitioners should be able to competently perform this complex work and deliver high-quality audits.

Editor’s note: Jay Hanson is speaking for himself, and his views do not necessarily represent those of the Board or the PCAOB as a whole.

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