New PCAOB Audit Risk Assessment Standards
Master the Guidelines for Analyzing Material Risk of Misstatements in Financials

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today’s panel features:

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Thursday, September 30, 2010

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1 pm Eastern
12 pm Central
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New PCAOB Audit Risk Assessment Standards Webinar

Sept. 30, 2010

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Today’s Program

PCAOB’s Goals With New Standards  
(Beila Sherman)  
Slides 6-21

Material Terms Of New Standards  
(Beila Sherman, Clarence Ebersole and Richard Gesseck)  
Slides 22-54

Likely Compliance Scenarios To Come  
(Richard Gesseck and Clarence Ebersole)  
Slides 55-63
PCAOB’s Goals With New Standards

Beila Sherman, MarcumRachlin
The PCAOB

- The PCAOB is a private sector, non-profit corporation.
- Created by the Sarbanes-Oxley Act of 2002 to oversee the auditors of companies.
- To protect investors and the public interest by promoting informative, fair and independent audit reports.
- The Act required that auditors of U.S. companies be subject to external and independent oversight (for the first time in history).
- The five members of the PCAOB Board, including the chairman, are appointed to staggered five-year terms by the Securities and Exchange Commission (SEC).
The SEC has oversight authority over the PCAOB, including the approval of the Board’s rules, standards and budget.
The PCAOB mission, as derived from the Sarbanes-Oxley Act of 2002, is to oversee the auditors of companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports.
The PCAOB seeks to be a model regulatory organization. Using innovative and cost-effective tools, the PCAOB aims to improve audit quality, reduce the risks of auditing failures in the U.S. public securities market and promote public trust in both the financial reporting process and auditing profession.
PCAOB Timeline

- July 30, 2002: Sarbanes-Oxley Act of 2002 is enacted, establishing the PCAOB.
- April 16, 2003: Board adopts AICPA standards as interim auditing standards (to SAS 100).
- April 25, 2003: PCAOB receives SEC determination, as required by the Sarbanes-Oxley Act, that it is appropriately organized, with the capacity to carry out the Act’s requirements.
- May 6, 2003: Board adopts audit firm registration rules
- Dec. 17, 2003: Board adopts AS No. 1: References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board
- March 9, 2004: Board adopts AS No. 2: An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements
May 16, 2005: Board issues *Policy Statement Regarding Implementation of AS No. 2: An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*


Jan. 22, 2007: Board issues *Observations on Auditors’ Implementation of PCAOB Standards Relating to Auditors’ Responsibilities with Respect to Fraud*
PCAOB Timeline (Cont.)


- The PCAOB initially proposed a suite of risk assessment standards on Oct. 21, 2008.

- Sept. 24, 2009: Board issues report on first-year implementation of AS No. 5
December 17, 2009: PCAOB re-proposed a suite of auditing standards related to an auditor’s assessment of and responses to risk, in the context of an integrated audit of financial statements and internal control over financial reporting.

These standards were issued as Release No. 2010-004, effective for audits of fiscal periods beginning on or after December 15, 2010.

The standards supersede six interim auditing standards: AU 311, Planning and Supervision; AU 312, Audit Risk and Materiality in Conducting an Audit; AU 313, Substantive Tests Prior to the Balance Sheet Date; AU 319, Consideration of Internal Control in a Financial Statement Audit; AU 326, Evidential Matter; and AU 431, Adequacy of Disclosure in Financial Statements.
Under Sect. 404 of the Sarbanes-Oxley Act, public companies and their independent auditors are each required to report to the public on the effectiveness of a company’s internal controls.

Non-accelerated filers, with a public float below $75 million, were given extra time to design, implement and document their internal controls before their auditors under Sect. 404(b) were required to attest to the effectiveness of the controls.

Congress just passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, a permanent exemption from complying with Sect. 404(b) of the Sarbanes-Oxley Act of 2002 for non-accelerated filers.
In March 2006, AICPA issued eight SASes that provide extensive guidance on how to apply the audit risk model in the planning and performance of a financial statement audit.

- These SASes became effective for audits of financial statements for periods beginning on or after Dec. 15, 2006.

The SASes describe a process for applying the audit risk model to gather audit evidence and form an opinion about a client's financial statements.

Those concepts include the following:
- The meaning of reasonable assurance
- Audit risk and the risk of material misstatement
- Audit evidence
AICPA
Risk Assessment Standards (Cont.)

- Concepts (Cont.)
  - Materiality and tolerable misstatement
  - Financial statement assertions
  - Internal control
  - Information technology

- SAS # 104, Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")

- SAS # 105, Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards (expands the scope of the understanding that the auditor must obtain in the second standard of field work from “internal control” to “the entity and its environment, including its internal control”).
SAS # 106, *Audit Evidence* identifies “risk assessment procedures” as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal controls, to assess the risk of material misstatement at the financial statement and relevant assertion levels.

SAS # 107, *Audit Risk and Materiality in Conducting an Audit*: Must consider audit risk and determine a materiality level for the financial statements taken as a whole for the purposes of determining the extent and nature of risk assessment procedures; identifying and assessing the risk of material misstatements; determining the nature, timing and extent of further audit procedures; and evaluating whether the financial statements taken as a whole are presented fairly, in conformity with GAAP.
SAS # 108, *Planning and Supervision*: Provides guidance on:

- Appointment of the independent auditor
- Establishing an understanding with the client
- Preliminary engagement activities
- The overall audit strategy
- The audit plan
- Determining the extent of involvement of professionals possessing specialized skills
- Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit
- Additional considerations in initial audit engagements
- Supervision of assistants
SAS # 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

States the auditor should assess the risk of material misstatement at both the financial statement and relevant assertion levels.

Provides directions on how to evaluate the design of the entity’s controls and determine whether the controls are adequate and have been implemented.

Directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration, or are risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.
AICPA
Risk Assessment Standards (Cont.)

- SAS # 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses. It also defines further audit procedures (which may include tests of controls) or substantive procedures should be responsive to the assessed risk of material misstatement at the relevant assertion level. Guidance is given on matters the auditor should consider in determining the nature, timing and extent of such audit procedures.

- SAS # 111, Amendment to Statement on Auditing Standards No. 39, audit sampling
Material Terms Of New Standards

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Audit Risk
Auditing Standard No. 8

- The objective of the auditor is to conduct an audit of financial statements in a matter that reduces audit risk to an appropriately low level.

- The auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud.

- Reasonable assurance is obtained by reducing audit risk to an appropriate low level by applying due professional care, including obtaining sufficient appropriate audit evidence.
Audit Risk
Auditing Standard No. 8 (Cont.)

- Audit risk is the risk that the auditor expresses an inappropriate audit opinion such as an unqualified opinion, when the financial statements are in fact materially misstated.
Risk of material misstatement (RMM) refers to the risk that the financial statements are misstated.

- RMM at the financial statement level relates to the financial statements as a whole such as an ineffective control environment, lack of financial resources to continue operations, and declining industries such as real estate in various areas of the country.
- RMM at the assertion level consists of inherent risk and control risk.
- Inherent risk (IR) and control risk (CR) relate to the company, its environment and its internal control which an auditor must assess.
- Detection risk is the risk that the procedures performed by the auditor will not detect a material misstatement that exists.
The objective of the auditor is to plan the audit so it is conducted effectively.

The engagement partner is responsible for the engagement and its performance. If engagement team members assist the engagement partner with planning, they should comply with this standard.

Planning the audit includes establishing an overall audit strategy for the engagement and developing an audit plan, which includes planned risk assessment procedures and planned responses to the risks of material misstatement.

Planning is a continual and iterative process.
Audit Planning
Auditing Standard No. 9 (Cont.)

- Preliminary engagement activities
  - Acceptance or continuance procedures per firm’s guidance
  - Ensure in compliance with independence and ethics requirements
  - Establish an understanding with the client regarding the services to preliminary engagement activities

- Planning activities
  - Consider the size and complexity of the company
  - Consider previous experience with company
  - Consider internal control
  - Consider matters affecting the industry, operations, legal matters
Audit strategy

- The auditor should establish an overall strategy that sets the scope, timing and direction of the audit and guides the development of the audit plan; and takes into account:
  - The reporting objectives of the engagement and the nature of the communications required by the PCAOB
  - The factors that are significant in directing the activities of the engagement team
  - Results of the preliminary engagement activities (client acceptance, continuance procedures and planning activities stated previously)
  - Nature timing and resources necessary to perform engagement
Audit Planning
Auditing Standard No. 9 (Cont.)

- Audit plan
  - The auditor is to develop and document an audit plan to include a description of:
    - The planned nature, timing and extent of the risk assessment procedures (AS No. 12 Identifying and Assessing Risks of Material Misstatement)
    - The planned nature, timing and extent of tests of controls and substantive procedures (AS No. 13 Auditor’s Responses to the RMM and AS No. 5)
    - Other planned audit procedures required to be performed to comply with OCAOB standards
Audit Planning
Auditing Standard No. 9 (Cont.)

- Other items
  - Considerations for multi-location engagements
  - Changes during the course of the audit
  - Persons with specialized skill or knowledge
  - Additional considerations in initial audits
Auditing Standard No. 10: Supervision Of The Audit Engagement

- Proposed standards included a standard that combined the topic of supervision with audit planning.

- Final standard included significantly more content than originally proposed:
  - A separate section added the responsibilities of the engagement partner for supervision.
  - Additional language on the supervision responsibilities of engagement team members
Auditing Standard No. 10: Supervision Of The Audit Engagement (Cont.)

- Responsibilities of the engagement partner
  - Responsible for the engagement and its performance
  - Responsible for proper supervision of the engagement team
  - Responsible for compliance with PCAOB standards (standards regarding use of work of specialists, other auditors and internal auditors are specifically mentioned).

- Engagement partner may seek assistance from engagement team members to fulfill their responsibilities.

Comment: Specificity of engagement partner responsibilities for supervision has increased.
Auditing Standard No. 10: Supervision Of The Audit Engagement (Cont.)

- Requirements to supervise engagement team members
  - Inform engagement team members of their responsibilities
  - Direct engagement team members to bring significant issues to the attention of supervisors
  - Review work of engagement team members

Comment: Again, requirements are more specific.
Auditing Standard No. 10: Supervision Of The Audit Engagement (Cont.)

- Extent of supervision should be determined in consideration of:
  - Nature of the company, including its size and complexity,
  - Nature of the assigned work for each engagement team member,
  - Risks of material misstatement, and
  - Knowledge, skill and ability of each engagement team member

Comment: Although consideration of these matters occurred in the past, their specific inclusion in this standard will necessitate additional documentation by the auditor.
Auditing Standard No. 10: Supervision Of The Audit Engagement (Cont.)

• Supervision of specialists, whether employed by the auditor or engaged by the auditor
  – The same supervisory requirements applicable to engagement team members also apply to specialists.

• The standard also states that engagement team members have the responsibility to bring to the attention of appropriate persons, those disagreements or concerns they have with respect to accounting and auditing issues.
Auditing Standard No. 10: Supervision Of The Audit Engagement (Cont.)

• Background on additional emphasis on supervision
  – PCAOB Release No. 2010-005: “… execution of … supervisory processes … suffers from a lack of diligence.”
  – This release reminds auditors that the PCAOB has the right under SOX to impose sanctions on auditing firms or its supervisory persons for a failure to reasonably supervise.
  – This release also indicates the PCAOB’s intentions to consider additional requirements for auditing firms to document clear assignments of supervision responsibilities to:
    • Avoid confusion within the firm regarding this responsibility
    • Identify the person with relevant supervision responsibility when a violation has occurred
Auditing Standard No. 10: Supervision Of The Audit Engagement (Cont.)

- PCAOB is very focused on supervision. They have commented specifically on failures that have occurred when an auditor relies on the work of a foreign firm for a multi-national audit.

Comment: Based on comments from the PCAOB, additional rulemaking in this area is very likely. Auditors are likely to reassess their supervision practices and documentation, particularly related to the use of foreign firms, and make any appropriate changes.
Auditing Standard No. 11: Consideration Of Materiality

• Materiality will now be based on a legal standard used by the courts in interpreting federal securities laws. The Supreme Court has held 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.”

• The Supreme Court has also noted that determinations of materiality require “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him … ”
Auditing Standard No. 11: Consideration Of Materiality (Cont.)

• Net earnings are often an important factor in the total mix of information available to a reasonable investor, but auditors are not required to use earnings as a basis for the established materiality in all cases.

• Both quantitative and qualitative factors should be considered.

• Circumstances that might lead to establishing lower levels of materiality for certain accounts or disclosures might include:
  – Investor expectations about the measurement or disclosure of certain items, such as related party transactions and compensation of senior management
Auditing Standard No. 11: Consideration Of Materiality (Cont.)

- Significant attention on a particular aspect of the company’s business that is separately disclosed in the financial statements, such as a recent business combination
- Certain disclosures that are particularly important to investors in the industry in which the company operates

• Lesser materiality levels may be appropriate for certain accounts or disclosures, if such amounts would influence the judgment of a reasonable investor.
Auditing Standard No. 11: Consideration Of Materiality (Cont.)

- For companies with multiple locations or business units, the auditor is required to determine materiality separately for individual locations or business units, based on probability of misstatement of the consolidated financial statements.

Comment: Companies need to discuss with their auditors the impact of this standard on their audits. It will take time for auditors to work with the new definition of materiality and determine its impact.
Auditing Standard No. 12: Identifying And Assessing Risks Of Material Misstatement

- This standard discusses the auditor’s responsibilities for performing “risk assessment procedures,” and identifying and assessing the risks of material misstatement using information obtained from performing risk assessment procedures.

- The auditor’s objective is to identify and appropriately assess the risks of material misstatement, providing a basis for designing and implementing responses to these risks in their audits.

- Concept is similar to that in the AICPA’s risk assessment standards that were effective for 2007.
Auditing Standard No. 12: Identifying And Assessing Risks Of Material Misstatement (Cont.)

- Risk assessment procedures include:
  - Obtaining an understanding of the company and its environment
  - Obtaining an understanding of internal control over financial reporting
  - Considering client acceptance and retention evaluations, audit planning activities, past audits and other engagements performed for the company
  - Performing analytical procedures
  - Discussions among the engagement team regarding risks of material misstatement
  - Inquiries of the audit committee, management and others regarding risks of material misstatement
Auditing Standard No. 12: Identifying And Assessing Risks Of Material Misstatement (Cont.)

• The audit requirements include consideration of other engagements performed for the company by the auditing firm. For example, if the auditing firm consulted with the company on tax planning issues, the auditor should discuss this engagement with those that provided the services to consider how the audit could be affected.

• The audit requirements also emphasize consideration of matters about the company, such as:
  – Information provided to the public about the company, such as from earnings calls, press releases and analyst reports
  – Compensation arrangements with senior management
  – Trading activity in the company’s securities and holdings in the company’s securities by significant holders
Auditing Standard No. 12: Identifying And Assessing Risks Of Material Misstatement (Cont.)

• The standard also emphasizes the auditor’s consideration of disclosures in the company’s financial statements, including:
  – Developing expectations about necessary disclosures
  – Requirement for the engagement team to discuss how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures

Comment: The assessment of risk of material misstatement, although part of audits in the past, will likely become more thorough, and documentation will increase.
Responding To Risks Of Material Misstatement (AS No.13)

• Overall response, including fraud considerations

• Response at assertion level by significant account, including fraud considerations
Components Of Overall Response

- Audit approach (extensive substantive procedures or rely on controls to reduce substantive procedures)
- Team assignments (includes specialists)
- Supervision
- Emphasis on subjective estimates and complex transactions
- Unpredictability – see next slide
Unpredictability

1. Out-of-scope (e.g., journal entries)

2. Timing

3. Items with amounts less than customary selection parameters

4. Unannounced

5. Multi-locations: Vary location or scope
Response At Assertion Level For Significant Accounts

1. Response based on combined risk assessment, which includes inherent and control risk

2. Control risk based on design effectiveness and operating effectiveness

3. Nature, timing and extent of tests of controls and substantive tests

4. Response integrates fraud considerations
Tests Of Controls In Financial Statement Audit

- Test controls to assess RMM at less than maximum
- Design effectiveness (inquire, observe, inspect documents, walk-throughs)
- Operating effectiveness (inquire, observe, inspect, re-perform)
- Nature of control tests
- Extent of control tests (frequency of control, expected deviations)
- Timing of control tests and period covered
- Updating (results of control and substantive tests, changes in ICFR, length of intervening period, etc.)
Substantive Tests

Significant accounts and assertions
  Nature, timing and extent
  Remaining population
  Updating (interim results, changes in ICFR, significant and unusual transactions, risk RMM will occur and not be detected by ICFR, etc.)

FSCP: Agree financial statements to accounting records; examine material adjustments
Response To Fraud Risk

Nature, timing and extent

Journal entries

Accounting estimates (bias)

Significant unusual transactions (business purpose)
Evaluating Audit Results (AS No. 14)

Misstatements
- Understand (systemic, isolated, indicative of fraud, response)
- Accounting estimates (unreasonable, bias)
- Projecting
- Aggregate misstatements approach PM

Uncorrected misstatements
- Schedule format
- Quantitative and qualitative analysis
Audit Evidence (AS No. 15)

✓ All information to support opinion
✓ Relevant and reliable
✓ Company produced information (test underlying data or controls over data)
✓ Procedures: Inspect, observe, inquire, confirm, recalculate, re-perform, analytical
✓ Selecting items to test: All items, specific items and audit sampling
Likely Compliance Scenarios To Come

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Audits Of Entities With Only 404(a) Control Requirements

• Default to maximum risk, checklists - inquiry only
• Additional documentation required
• Risk assessment (overall and assertion level for significant accounts)
• Understanding of entity and entity level controls, risk assessment and response
• FSCP, risk assessment and response
• Significant accounts and underlying processes (routine and non-routine and estimation processes)
• Inherent, control and combined risk for assertions for significant accounts and response
Additional Emphasis On Fraud

• The PCAOB risk assessment standards seek to emphasize the auditor’s responsibilities for consideration of fraud.

• The auditor’s responsibilities for assessing and responding to fraud risks are considered by the new standards to be an integral part of the audit process, not a separate process. Previous requirements with respect to identifying and assessing fraud risks have been incorporated into Auditing Standards Nos. 12, 13 and 14 to help accomplish this integration.

• Auditors are prompted to “make a more thoughtful and thorough assessment of fraud risks and to develop appropriate audit responses.”
Audit Committee Issues

• Consistent with the audit committee’s responsibilities for oversight of a company’s audit function, the impact of these risk assessment standards on audit quality should be considered a positive development.

• The risk assessment standards include specific requirements affecting the audit committee, including:
  – Taking into account in developing the overall audit strategy the communications with the audit committee
  – Inquiry of the audit committee about the risks of material misstatement
Audit Committee Issues (Cont.)

- Understanding the policies and actions of the audit committee as part of assessing the company’s control environment, including whether the audit committee understands and exercises oversight responsibility over financial reporting and internal control.
- Understanding how communication takes place between management, the audit committee and the board.
- Inquiry about the audit committee’s whistleblower program.
- Asking management about their communications with the audit committee regarding how the company’s internal control serves to prevent and detect fraud.
Audit Committee Issues (Cont.)

- Asking the audit committee about:
  - Fraud risks in the company
  - Their knowledge of fraud, alleged fraud or suspected fraud
  - How the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks

- Considering impact on assessment of fraud risk of objections by management to the auditor meeting privately with the audit committee
Audit Committee Issues (Cont.)

- The proposed PCAOB standard on communications with audit committees will also affect the extent of required communications of audit committees with the company’s external auditor.
  - Proposed effective date is for audits for fiscal years beginning after Dec. 15, 2010.
  - Among other items, requirements include communications re:
    - Significant risks identified and timing of the audit
    - Roles, responsibilities and locations of firms participating in the audit
    - Significant accounting matters on which the auditor consulted outside the engagement team (e.g., industry specialists; national office consultations)
Comparison To IAASB And ASB

• Standards similar
• PCAOB provides enhancements to improve audit quality and effectiveness
• Some specific differences in objectives and requirements
  ➢ AS 11 requires auditor to “take into account” nature, cause and amount of misstatements in prior periods when determining TM.
  ➢ AS 11 requires auditor to evaluate whether significant changes in entity from prior periods affect RMM.
  ➢ AS 12 requires auditor to read transcript of earnings calls, understand compensation arrangements with senior management, and obtain info about trading activity by significant holders.
  ➢ AS 12 requires auditor to consider if control deficiency is indicative of a fraud risk factor.
Specific Differences (Cont.)

- AS 12 requires auditor to integrate IT risk assessment with approach for significant accounts and underlying flow of transactions.

- AS 12 requires communication of matters affecting RMM continuously throughout audit (i.e. updating brainstorming session).

- AS 12 requires auditor to make inquiries of audit committee about tips and complaints about entity’s financial reporting.

- Others