
STAFF AUDIT PRACTICE ALERT NO. 9

ASSESSING AND RESPONDING TO RISK IN THE CURRENT ECONOMIC ENVIRONMENT

December 6, 2011

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Background

In December 2008, Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* ("Practice Alert No. 3"),^{1/} was issued to assist auditors in identifying matters related to the then-current economic environment that might affect the risk of material misstatement of issuers' financial statements and the related auditor's responsibilities under Public Company Accounting Oversight Board ("PCAOB" or "the Board") standards.

Since the issuance of Practice Alert No. 3, economic conditions have been slower to recover than many had originally anticipated.^{2/} Uncertainty continues regarding global economic conditions, and certain volatility indicators are higher than they were before the financial crisis. 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.

^{1/} See Staff Audit Practice Alert No. 3 on the Board's web site at: http://pcaobus.org/Standards/QandA/12-5-2008_APA_3.pdf.

^{2/} 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).

growth from 2.7% to 1.8%.^{3/} In November 2011, the Federal Reserve Board also reduced its projections for short- and longer-term GDP while increasing its estimated unemployment rate.^{4/} While countries work toward addressing their economic challenges, market volatility continues, and economic conditions may vary significantly among different regions or sectors of the economy.

Difficult economic conditions may affect companies' operations and financial reporting and, in turn, may have implications for audits of financial statements and internal control over financial reporting. Matters discussed in Practice Alert No. 3, such as auditing fair value measurements, auditing accounting estimates, the auditor's consideration of a company's ability to continue as a going concern, and auditing financial statement disclosures, continue to be critical in the current economic environment.

Although many of the risks discussed in Practice Alert No. 3 continue to have relevance, a number of the auditing standards referenced in that alert regarding the auditor's assessment of and response to risk were superseded in 2010 when the Board adopted a suite of eight new auditing standards ("risk assessment standards").^{5/} The risk assessment standards, which enhance the effectiveness of the auditor's assessment of and response to risk of material misstatement in an audit, became effective for audits of fiscal years beginning on or after December 15, 2010. As compared to the Board's interim standards, the risk assessment standards, among other things, establish enhanced requirements pertaining to the performance of risk assessment procedures, provide additional factors relevant to identifying significant risks, and enhance requirements for auditing financial statement disclosures. Auditors

^{3/} On September 15, 2011, Christine Lagarde, Managing Director of the IMF, 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 full text of Ms. Lagarde's speech is available at: <http://www.imf.org/external/np/speeches/2011/091511.htm>.

^{4/} See Federal Reserve Board "*Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, November 2011*," available at: <http://www.federalreserve.gov/newsevents/press/monetary/20111102b.htm>.

^{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](http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release%202010-004%20Risk%20Assessment.pdf).

should be alert to the new requirements contained in the risk assessment standards and how those requirements relate to audits performed in the current economic climate.

The purpose of this staff audit practice alert is to assist auditors in identifying matters related to the current economic environment that might affect the risk of material misstatement and, therefore, require additional audit attention. The practice alert discusses certain issues posed by the current economic environment, highlights certain requirements in the risk assessment standards, and is organized into four sections:

- Considering the impact of economic conditions on the audit;
- Auditing fair value measurements and estimates;
- The auditor's consideration of a company's ability to continue as a going concern; and
- Auditing financial statement disclosures.

While the alert highlights certain issues, it is not intended to identify all issues that might affect audit risk in the current economic environment or serve as a substitute for the relevant auditing standards. All audits of issuers must be conducted in accordance with the standards of the PCAOB.

Considering the Impact of Economic Conditions on the Audit

As year-end approaches for many issuers, changing economic conditions might require the auditor to reassess the appropriateness of the planned audit strategy, materiality levels, risk assessments (including identified fraud risks and other significant risks), and planned audit responses. Such a reassessment is especially important if the auditor planned the audit and performed the initial risk assessment procedures early in the year or performed initial testing as of or through an interim date.

Audit Planning and Materiality Considerations

Audit planning is not a discrete phase of an audit but, rather, a continual and iterative process.^{6/} The nature and extent of planning activities that are necessary depend on, among other things, changes in circumstances that occur during the audit.^{7/} Accordingly, the auditor should modify the overall audit strategy and the audit plan as

^{6/} See paragraph 5 of Auditing Standard No. 9, *Audit Planning*.

^{7/} See paragraph 7 of Auditing Standard No. 9.

necessary if circumstances change significantly during the course of the audit.^{8/} For example, in an audit of the financial statements of a company with operations in multiple locations, changes in regional economic conditions might alter the risks associated with certain locations, which in turn, could affect the selection of locations for testing or determination of extent of testing at selected locations.^{9/}

The current economic environment may also require the auditor to re-evaluate the established materiality level or levels and tolerable misstatement (e.g., if the auditor initially established the materiality level or levels and tolerable misstatement based on estimated or preliminary financial statement amounts that differ significantly from actual amounts).^{10/} The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor.^{11/} If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures.^{12/} For example, this might be appropriate if certain financial statement line items are particularly important to a regulatory requirement or a debt covenant.

Risk Assessment

The effectiveness of a risk-based audit approach is dependent on the ability of the auditor to identify the risks of material misstatement and to have an appropriate basis for assessing those risks. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements, including the auditor's responsibilities for performing risk assessment procedures.

Examples of risk assessment procedures that may provide particularly relevant information in identifying and assessing the risks of material misstatement in the current economic environment include, among other things:

^{8/} See paragraph 15 of Auditing Standard No. 9.

^{9/} See paragraphs 11-14 of Auditing Standard No. 9.

^{10/} See paragraph 11 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

^{11/} Paragraph 7 of Auditing Standard No. 11.

^{12/} Ibid.

- Reading public information about the impact of the current economic environment on the company, including, for example, analyst reports and company-issued press releases.^{13/}
- Obtaining an understanding of the company's performance measures (including, for example, performance measures that form the basis for contractual commitments or incentive compensation arrangements or measures used by external parties, such as analysts and rating agencies, to review the company's performance).^{14/} When slowdowns in a company's market or industry reduce the likelihood that a company will meet its consensus earnings estimate, there could be additional pressure on management to manipulate the financial statements to achieve this estimate.^{15/}
- Obtaining an understanding of a company's current and prospective financing requirements. In the current economic environment, companies may not be able to regularly access funds through short-term borrowings, may have other liquidity issues, such as significant collateral calls or a lack of acceptable collateral, may be at risk of violating debt covenants, or may have significant tranches of debt becoming due within one year. In such cases, companies may be unable to settle their obligations as they become due. In turn, this situation could affect the risks of material misstatement related to, for example, the classification of long-term liabilities or valuation of long-term assets, or it could result in substantial doubt about the company's ability to continue as a going concern.^{16/}
- Performing analytical procedures designed to enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year-end and identify areas that might represent specific risks relevant to the audit.^{17/} When performing an analytical procedure, the auditor should use his or her understanding of

^{13/} See paragraph 11 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

^{14/} See paragraphs 16-17 of Auditing Standard No. 12.

^{15/} See, for example, paragraph 52 of Auditing Standard No. 12 and paragraph .85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{16/} See paragraph 14-15 of Auditing Standard No. 12.

^{17/} See paragraph 46 of Auditing Standard No. 12.

the company to develop expectations about plausible relationships among the data to be analyzed.^{18/}

The risk assessment standards include requirements for the auditor to incorporate knowledge obtained during past audits and interim reviews into the auditor's process for identifying risks of material misstatement; however, in a changing economic environment, the auditor should evaluate whether the prior years' information remains relevant and reliable.^{19/} For example, when performing an analytical procedure in the current economic environment, prior period financial information may not be an appropriate data point in developing an expectation.

The risk assessment standards also require the auditor's assessment of the risks of material misstatement to continue throughout the audit.^{20/} For example, significant changes in industry or market conditions near year-end, such as a sovereign debt rating downgrade in a market in which a company has a concentration of customers, 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 assessments and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.^{21/}

Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.^{22/} For instance, the results of the "brainstorming" discussion among the key engagement team members about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud may need to be updated to reflect additional fraud risks that could result from the specific effects of the current economic environment on the company.^{23/}

^{18/} See paragraph 48 of Auditing Standard No. 12.

^{19/} See paragraphs 42-44 of Auditing Standard No. 12.

^{20/} See paragraph 74 of Auditing Standard No. 12.

^{21/} Ibid.

^{22/} Paragraph 51 of Auditing Standard No. 12.

^{23/} See paragraph 52 of Auditing Standard No. 12.

Identifying Fraud Risks and Other Significant Risks

In identifying and assessing risks of material misstatement, the auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks.^{24/} Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets* ("Practice Alert No. 8"), issued in October 2011, focuses on fraud risks that auditors might encounter in audits of companies with operations in emerging markets and auditors' responsibilities for addressing those risks.^{25/} While the focus of Practice Alert No. 8 was on emerging markets, fraud risks may be encountered in audits of companies in any region, especially when the company is faced with challenging economic conditions. In addition, auditors are reminded that their consideration of fraud includes misstatements from the misappropriation of assets.^{26/}

Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action.^{27/} Incentives or pressures to perpetrate fraud may exist when:

- Financial stability or profitability is threatened by economic conditions. For example, in the current economic environment, a company with substantial direct or indirect sovereign debt exposure may be motivated to not consider all relevant market information when determining a fair value measurement or enter into off-balance sheet arrangements that fail to be appropriately accounted for or disclosed.^{28/}

^{24/} Paragraph 65 of Auditing Standard No. 12.

^{25/} See Staff Audit Practice Alert No. 8 on the Board's web site at: <http://pcaobus.org/Standards/Pages/Guidance.aspx>.

^{26/} See AU sec. 316.06.

^{27/} Paragraph 65 of Auditing Standard No. 12.

^{28/} Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, discussed audit considerations regarding significant transactions that are outside the normal course of business for a company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. See Staff Audit Practice Alert No. 5 on the Board's website at: http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.

- Excessive pressure exists for management to meet the requirements or expectations of third parties (e.g., due to expectations created by management in, for example, press releases or annual report messages that are no longer realistic).
- There is excessive pressure on operating personnel, including, for example, operating personnel in remote locations, to meet financial targets set by management, including sales or profitability incentive goals.^{29/}

In identifying and assessing risks of material misstatement, the auditor should determine whether any of the auditor's identified and assessed risks are significant risks.^{30/} A significant risk is defined as "[a] risk of material misstatement that requires special audit consideration."^{31/} To determine whether a risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.^{32/} One of the factors that should be evaluated in determining which risks are significant risks is whether the risk is related to recent significant economic developments.^{33/} Accordingly, risks of material misstatement that may be particularly susceptible to changes in the economic environment should be evaluated in this context. Other factors that the auditor should evaluate in determining significant risks include:^{34/}

- 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;
- Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature; and

^{29/} AU sec. 316.85 A.2 describes further examples of risk factors relating to misstatements arising from fraudulent financial reporting.

^{30/} See paragraph 59f of Auditing Standard No. 12.

^{31/} Paragraph A5 of Appendix A to Auditing Standard No. 12.

^{32/} See paragraph 70 of Auditing Standard No. 12.

^{33/} See paragraph 71 of Auditing Standard No. 12.

^{34/} Ibid.

- Whether the risk involves significant transactions with related parties. Transactions with related parties may be motivated solely, or in large measure, by conditions such as a lack of sufficient working capital or credit to continue the business, an overly optimistic earnings forecast, or a declining industry characterized by a large number of business failures.^{35/}

Planned Audit Responses

When the identified and assessed risks of material misstatement change, corresponding changes to planned audit responses may be necessary to adequately address the assessed risks.^{36/} Depending on the circumstances, these changes may need to be pervasive.^{37/} An example of such a pervasive change includes modifying the audit strategy to increase the substantive testing of the valuation of numerous significant accounts at year-end because of significant volatility in market conditions.^{38/}

For significant risks, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.^{39/} Accordingly, for significant risks, the auditor's substantive procedures should include tests of details that are specifically responsive to the assessed risks.^{40/}

When using an analytical procedure as a substantive test, the expected effectiveness of the procedure depends on, among other things, the plausibility and predictability of relationships among financial and non-financial data.^{41/} As higher levels of assurance are desired from analytical procedures that are used as substantive procedures, more predictable relationships are required to develop the expected

^{35/} See paragraph .06 of AU sec. 334, *Related Parties*.

^{36/} See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

^{37/} See paragraph 6 of Auditing Standard No. 13.

^{38/} Ibid.

^{39/} See paragraph .09 of AU sec. 329, *Substantive Analytical Procedures*.

^{40/} See paragraph 11 of Auditing Standard No. 13.

^{41/} See AU sec. 329.11.

analytical relationships.^{42/} Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment.^{43/}

When testing controls over relevant assertions in an audit, the auditor should evaluate whether the controls are designed and operating effectively.^{44/} Practice Alert No. 3 discussed matters that may require additional auditor attention regarding the effective operation of internal controls, including job eliminations that may increase the risk of deficiencies in internal control over financial reporting because of, for example, lack of segregation of duties or lack of effective monitoring controls.

Auditing Fair Value Measurements and Estimates

The current economic environment continues to present challenges relating to auditing fair value measurements and estimates.^{45/} When auditing accounting estimates, the auditor should perform procedures to determine whether the accounting estimates are determined in conformity with the applicable financial reporting framework, are reasonable, and do not result in bias that materially misstates the financial statements.^{46/} When testing management's process for determining fair value measurements or estimates, the auditor should perform procedures commensurate with

^{42/} See AU sec. 329.14.

^{43/} Ibid.

^{44/} See, for example, paragraphs 16-22 of Auditing Standard No. 13.

^{45/} Fair value measurements and estimates were the subject of a number of audit deficiencies noted in the Board's Rule 4010 *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* (available at: http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf). In addition, fair value measurements and estimates were discussed in a number of previous staff audit practice alerts. See Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, Practice Alert No. 3, Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments*, and Staff Audit Practice Alert No. 7, *Auditor Considerations of Litigation and Other Contingencies Arising from Mortgage and Other Loan Activities*. Staff Audit Practice Alerts are available at: <http://pcaobus.org/Standards/Pages/Guidance.aspx>.

^{46/} See, for example, paragraph 23 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .11 of AU sec. 342, *Auditing Accounting Estimates*, and paragraphs 13 and 24-27 of Auditing Standard No. 14, *Evaluating Audit Results*.

the related risk, including considering whether significant assumptions are best supported by the available audit evidence.^{47/} For example:

- Significant assumptions used in fair value measurements and estimates that are based on past experience and management expectations, such as revenue projections, cash flow estimates, charge-off rates, or projected rate of return assumptions and discount rates used in determining pension liabilities, may not reflect current market information or be representative of expected future conditions or events.
- Reductions in forecasts of macro-economic growth or extended periods of low interest rates may affect important assumptions underlying certain estimates, such as impairment determinations or the valuation of servicing assets. Uncertainty regarding the value of certain types of collateral or increasing counter-party risk may affect the valuation of financial instruments.
- Additional risks, such as sovereign default risk or currency volatility, could add a higher level of complexity in determining the ultimate collectability of sales or the appropriateness of other significant assumptions used in certain fair value determinations or estimates, including the fair value of certain financial instruments.
- An active market may not exist for certain financial instruments which in turn may result in complex valuation methods. Assumptions are integral components of more complex valuation methods, for example, valuation methods that employ a combination of estimates of expected future cash flows together with estimates of the values of assets or liabilities in the future, discounted to the present. Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable and reflect, or are not inconsistent with, market information.^{48/}

^{47/} Ibid.

^{48/} AU sec. 328.29.

Auditors are reminded that audit evidence consists of both information that supports and corroborates management's assertions and information that contradicts such assertions including assertions regarding fair values, estimates and related disclosures.^{49/}

Bias in Accounting Estimates

Business conditions today may create increased pressures to achieve certain financial results that could result in bias in management's estimates.^{50/} Applying professional skepticism is of particular importance when evaluating estimates and assumptions in judgmental areas that are susceptible to management bias.

The auditor should evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management.^{51/} A lack of consistency in assumptions used to support different estimates might be indicative of errors or bias in estimates. For instance, revenue assumptions used in the goodwill impairment test that are inconsistent with revenue assumptions used to accrue discretionary compensation might be indicative of management bias. Further, bias might be evidenced by assumptions that are inconsistent with industry economic forecasts or the company's budgets or future business plans or the consistent use of overly optimistic assumptions (e.g. consistently missing projected revenue by a substantial amount in each recent period).^{52/} If each accounting estimate included in the financial statements is individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence is to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates.^{53/} Bias also can result from the cumulative effect of changes in multiple accounting estimates. If the estimates in the financial statements are grouped at one end of the range of reasonable estimates in the prior year and are grouped at the other end of the range of reasonable estimates in the current year, the auditor should evaluate whether management is using

^{49/} See paragraph 2 of Auditing Standard No. 15, *Audit Evidence*.

^{50/} See paragraph 25d of Auditing Standard No. 14.

^{51/} Paragraph 27 of Auditing Standard No. 14.

^{52/} See, for example, AU sec. 342.09.

^{53/} Paragraph 27 of Auditing Standard No. 14.

swings in estimates to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.^{54/}

If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements.^{55/} Also, the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.^{56/} Auditors are reminded that indications of management bias in accounting estimates and in selecting accounting principles may affect the auditor's conclusions about the operating effectiveness of controls and should be included in the auditor's evaluation of controls in an integrated audit.^{57/}

Consideration of Changes to Accounting Standards

Practice Alert No. 3 provided information on selected financial reporting areas that might be affected by the then-current economic environment. While these areas continue to pose audit and financial reporting risk, certain accounting requirements have been amended since the issuance of Practice Alert No. 3.^{58/} For example, the Financial Accounting Standards Board ("FASB") recently issued Accounting Standards Codification Update 2011-08, *Intangibles-Goodwill and Others (Topic 350): Testing Goodwill for Impairment* ("ASU No. 2011-08").^{59/} That guidance allows companies to

^{54/} Ibid.

^{55/} Paragraph 26 of Auditing Standard No. 14.

^{56/} Ibid.

^{57/} See paragraph B8 of Appendix B to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements*.

^{58/} The Board has no authority to prescribe the form or content of a company's financial statements. That authority, and the authority to make binding determinations concerning compliance with generally accepted accounting standards ("GAAP"), rests with the U.S. Securities and Exchange Commission. Accordingly, while this staff audit practice alert describes applicable GAAP, it does not establish or interpret GAAP.

^{59/} See <http://www.fasb.org/cs/ContentServer?site=FASB&c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176156316498>.

first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350.^{60/}

If a company opts to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, ASU No. 2011-08 provides examples of events and circumstances that the company should consider in its evaluation.^{61/} These examples include, among others:

- Macroeconomic conditions such as a deterioration in general economic conditions;
- Limitations on accessing capital;
- Fluctuations in foreign exchange rates, or other developments in equity and credit markets; and
- Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (considered in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development.^{62/}

When reviewing and testing the process for a company's assessment of qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value, audit considerations include, among others:

- Identifying the sources of data and factors that the company used in forming the assumptions, and consideration of whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.
- Considering whether there are additional key factors or alternative assumptions about the factors.

^{60/} ASU No. 2011-08 at 1.

^{61/} ASU No. 2011-08 at 2.

^{62/} ASU No. 2011-08, paragraph 350-20-35-3c.

- Evaluating whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- Considering whether changes in the business or industry may cause other factors to become significant to the assumptions.^{63/}

The Auditor's Consideration of a Company's Ability to Continue as a Going Concern

Practice Alert No. 3 noted certain challenges companies may face in their ability to continue operating as a going concern in light of the then-current economic environment. These challenges included a reduction of the availability of funding under lines of credit or from short-term borrowing markets, difficulty in meeting debt covenants, and a lack of acceptable collateral. Some companies may continue to face such challenges in the current economic environment.

The auditor has a responsibility to evaluate whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.^{64/} The auditor's going concern evaluation can affect the auditor's evaluation of financial disclosures and the auditor's report.^{65/}

The auditor's going concern evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.^{66/} Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in Auditing Standard No. 15, *Audit Evidence*.^{67/}

Conditions or events, such as negative trends and other indications of possible financial difficulties as well as internal and external matters that have occurred, when considered in the aggregate, may indicate there could be substantial doubt about the

^{63/} See AU sec. 342.11.

^{64/} Paragraph .02 of AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

^{65/} See AU secs. 341.12 and 341.14.

^{66/} AU sec. 341.02.

^{67/} See paragraph 11 of Auditing Standard No. 15.

company's ability to continue as a going concern for a reasonable period of time.^{68/} If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the auditor should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.^{69/}

Management's plans for dealing with the adverse effects of the conditions or events may include the disposal of assets, borrowing additional funds or restructuring existing debt, planned reduction of expenditures, or increasing equity by raising capital.^{70/} When evaluating management's plans, the auditor should identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and should plan and perform auditing procedures to obtain evidential matter about them.^{71/}

In the current economic environment, it is important for the auditor to consider the adequacy of support for such plans,^{72/} including whether it is likely that the adverse effects will be mitigated for a reasonable period of time and whether the plans can be effectively implemented.^{73/} For example, if management indicates that the company plans to dispose of assets to raise capital, audit considerations may include the existence of any restrictions on the disposal of the assets, issues related to the marketability of the assets, and any possible direct or indirect effects of disposal of the assets.^{74/} As another example, if management is relying on a pledge of financial support from a significant shareholder, consideration should be given to the impact of current economic conditions on the shareholder's ability to provide such funding.^{75/} Another

^{68/} See AU sec. 341.06.

^{69/} AU sec. 341.03.b.

^{70/} See AU sec. 341.07.

^{71/} AU sec. 341.08.

^{72/} Ibid.

^{73/} See AU sec. 341.07.

^{74/} Ibid.

^{75/} Such consideration may include information contained in, among other things, the audited financial statements of the shareholder, reports issued by regulatory

important consideration in the current economic environment is the willingness of a third party to continue to provide financial support, especially if the third party has already provided support to ongoing operations or in light of a potentially longer time frame for the company to return to profitability or positive cash flow.

When prospective financial information is particularly significant to management's plans, the auditor should request management to provide that information and should consider the adequacy of support for significant assumptions underlying that information.^{76/} In considering the adequacy of support for significant assumptions, the auditor should consider whether the assumptions are consistent with current economic conditions, such as, recent reductions in economic growth forecasts and information obtained by the auditor in other audit areas.

In the current economic environment, assumptions that are especially sensitive or susceptible to change and that are important to the auditor's evaluation of whether or not substantial doubt remains about the company's ability to continue as a going concern may warrant particularly careful consideration by the auditor.^{77/} When, primarily because of the consideration of management's plans, the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the need for disclosure in the financial statements, the principal conditions and events that initially caused him or her to believe there was substantial doubt, including the possible effects of such conditions and events, and any mitigating factors, including management's plans.^{78/}

Auditing Financial Statement Disclosures

The risk assessment standards recognize the importance of financial statement disclosures by directing the auditor's attention to them throughout the audit process. The current economic environment may increase the risk related to omitted, incomplete, or inaccurate disclosures, including, for example, disclosures regarding contingent liabilities, risks and uncertainties, concentrations of credit risk, and liquidity concerns.

agencies, financial publications, or credit agencies concerning the shareholder, and income tax returns of the shareholder, to the extent available.

^{76/} AU sec. 341.09.

^{77/} Ibid.

^{78/} See AU sec. 341.11.

The risk assessment standards require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional,^{79/} and to identify and test significant disclosures.^{80/} To identify and assess such risks, the auditor should 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.^{81/} The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.^{82/} The discussion among the key engagement team members should include how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.^{83/}

The nature of certain financial statement disclosure requirements, the complexity of the matters disclosed, and the qualitative nature of certain disclosures can pose additional risks of material misstatement. Also, internal controls over disclosures that are qualitative, judgmental, or complex often are different from those controls over the processing and reporting of routine historical transactions. For these types of disclosures, the necessary controls are more likely to be manual controls than automated controls and may require significant judgment in the operation of the control, which, in turn, can affect the risk associated with the control.

When evaluating whether the financial statements are fairly presented in conformity with the applicable financial reporting framework, the auditor also is required to evaluate the disclosures, which includes, among other things:

^{79/} See, for example, paragraphs 49, 52, and 67 of Auditing Standard No. 12.

^{80/} See, for example, paragraphs 59-64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13. A disclosure is a significant disclosure if there is a reasonable possibility that the disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements. See paragraph A10 of Auditing Standard No. 5.

^{81/} See paragraph 12 of Auditing Standard No. 12.

^{82/} Paragraph 49 of Auditing Standard No. 12.

^{83/} See paragraph 52 of Auditing Standard No. 12.

- Evaluating whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation;^{84/} and
- Considering the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.^{85/}

Evaluation of disclosures also involves evaluation of the effect on the financial statements of uncorrected misstatements in disclosures, such as omitted, incomplete, or inaccurate disclosures. Qualitative considerations are particularly important when evaluating misstatements in disclosures that are more narrative in nature, such as those relating to risks and uncertainties or loss contingencies where an estimate has not yet been disclosed.^{86/} PCAOB auditing standards describe the auditor's responsibilities for considering qualitative factors in the context of the auditor's consideration of materiality.^{87/}

To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account, among other things, the nature of the assigned work for each engagement team member, including the controls or accounts and disclosures to be tested.^{88/} For example, additional supervision over audit areas including disclosures that are more qualitative, judgmental, or complex in nature may be merited. Also, to effectively evaluate those disclosures, auditors need to exercise professional skepticism and be alert for events or conditions that may contradict management's

^{84/} See paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

^{85/} See paragraph 31 of Auditing Standard No. 14.

^{86/} Practice Alert No. 3 discussed communications with audit committee, including communications about the clarity and completeness of the financial statements, that include related disclosures.

^{87/} See, for example, paragraph 24 and Appendix B of Auditing Standard No. 14.

^{88/} See paragraph 6b(2) of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

assertions in the disclosures.^{89/} Events or conditions that may contradict information in the disclosures may arise during the performance of other audit procedures including reading information in documents containing audited financial statements or may be based on more general factors, such as conditions in the industry in which the company operates. PCAOB standards require auditors to read other information in documents containing audited financial statements and consider whether such information is materially inconsistent with information appearing in the financial statements, including disclosures.^{90/}

Obtaining audit evidence that is relevant for evaluating disclosures that are more judgmental or qualitative in nature might require different auditing procedures from those used to evaluate disclosures of routine historical data. For example, the evidence needed to evaluate a disclosure relating to a loss contingency might come from sources outside the company's accounting system or possibly from sources outside the company.

^{89/} See AU sec. 230, *Due Professional Care in the Performance of Work*.

^{90/} See paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

Contact Information

Inquiries concerning this Staff Audit Practice Alert may be directed to:

Martin F. Baumann, Chief Auditor and Director
of Professional Standards

202-207-9192,
baumannm@pcaobus.org

Keith Wilson, Deputy Chief Auditor

202-207-9134,
wilsonk@pcaobus.org

Michael Gurbutt, Associate Chief Auditor

202-591-4739,
gurbutm@pcaobus.org

Barbara Vanich, Associate Chief Auditor

202-207-9363,
vanichb@pcaobus.org

Dominika Taraszkievicz, Assistant Chief Auditor

202-591-4143,
taraszkieviczd@pcaobus.org