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STAFF AUDIT PRACTICE ALERT NO. 5

AUDITOR CONSIDERATIONS REGARDING SIGNIFICANT UNUSUAL TRANSACTIONS

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Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards 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 are not 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.

During the course of an audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment ("significant unusual transactions").[1/] Significant unusual transactions, especially those close to period end that pose difficult "substance over form" questions, can provide opportunities for companies to engage in fraudulent financial reporting.[2/] Further, the auditor's evaluation of whether the company's financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, includes the consideration of the financial statement presentation and disclosure of significant unusual transactions.[3/]

The auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transactions

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[1/] Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

[2/] AU sec. 316.85.

[3/] Paragraph .04 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, notes financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles.

may have been entered into to engage in fraudulent financial reporting or conceal a misappropriation of assets.[4/] The audit engagement team might consult with individuals having appropriate levels of knowledge, competence, and judgment regarding significant unusual transactions.[5/] Such consultations regarding significant unusual transactions should occur in accordance with the firm's policies and procedures. The auditor should determine that the audit committee is informed about the methods used to account for significant unusual transactions.[6/] In addition, the engagement quality reviewer cannot provide concurring approval of issuance if he or she is aware of a significant engagement deficiency, including those regarding significant unusual transactions.[7/]

Introduction

Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* ("Practice Alert No. 3"), was issued in December 2008 to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis.[8/] Practice Alert No. 3 reminds auditors that the auditors' response to the risks of material misstatement due to fraud includes evaluating the business rationale for significant unusual transactions. In the staff's view, although the economic conditions have changed since December 2008, the risk factors, including the risks of significant unusual transactions, that existed in December 2008 continue to exist today and may affect the risk of material misstatement.

The existing standards of the PCAOB contain a variety of requirements related to significant, unusual, or complex transactions, or a combination thereof. The purpose of this staff audit practice alert is to complement Practice Alert No. 3 by compiling selected, relevant requirements from existing PCAOB auditing standards regarding significant unusual transactions into one document. While this alert summarizes certain areas with respect to significant unusual transactions, it is not intended to, and does not, serve as a substitute for the relevant standards of the PCAOB. Nor does this alert change the

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4/ AU sec. 316.66.

5/ Paragraph .19 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

6/ Paragraph .07 of AU sec. 380, *Communication With Audit Committees*.

7/ Paragraphs 12 and 17 of Auditing Standard No. 7, *Engagement Quality Review*. AS No. 7 is effective for audits of financial statements and reviews of interim financial information for fiscal years beginning on or after December 15, 2009.

8/ Staff Audit Practice Alert No. 3 is available at http://pcaobus.org/Standards/QandA/12-05-2008_APA_3.pdf.

auditor's responsibilities regarding significant, unusual, or complex transactions. This alert reminds auditors of certain responsibilities with respect to significant unusual transactions and assists auditors in assessing and responding to the risks of material misstatement associated with these transactions during reviews of interim financial information and audits of financial statements, including integrated audits.

This alert groups the existing requirements for significant unusual transactions into the following categories: (1) identifying and assessing risks of material misstatement, (2) responding to risks of material misstatement, (3) consulting others, (4) evaluating financial statement presentation and disclosure,[9/] (5) communicating with audit committees, and (6) reviewing interim financial information.

Identifying and Assessing Risks of Material Misstatement

The auditor's identification of significant unusual transactions is informed by the performance of audit procedures and the auditor's knowledge of the company's business and industry. The auditor should obtain knowledge of matters that relate to the nature of the company's business, its organization, and its operating characteristics.[10/] Such matters include, for example, the type of business, types of products and services, and related parties.[11/] The auditor also should consider matters affecting the industry in which the company operates, such as accounting practices common to the industry, competitive conditions, and financial trends and ratios.[12/]

The auditor should consider whether the information obtained about the company and its environment indicates that one or more fraud risk factors are present, including significant unusual transactions.[13/] The auditor also should consider identified fraud risk factors in identifying and assessing risks of material misstatement due to fraud.[14/] In

9/ The PCAOB has no authority to prescribe the form or content of an issuer's financial statements. Accordingly, while this staff audit practice alert describes authoritative accounting guidance, it does not establish or interpret that accounting guidance. See Staff Questions and Answers, *References to Authoritative Accounting Guidance in PCAOB Standards*, available at http://pcaobus.org/Standards/QandA/2009-09-02_FASB_Codification.pdf.

10/ Paragraph .07 of AU sec. 311, *Planning and Supervision*.

11/ Ibid.

12/ Ibid.

13/ AU sec. 316.32.

14/ Ibid.

obtaining the information needed to identify risks of material misstatement due to fraud, the auditor, among other things, should inquire of others within the company about the existence or suspicion of fraud, including, for example, employees involved in initiating, recording, or processing significant unusual transactions.[15/] The auditor also should perform analytical procedures when planning the audit with one objective being the identification of significant unusual transactions.[16/] The auditor's assessment of the risks of material misstatement due to fraud, including those regarding significant unusual transactions, should be ongoing throughout the audit.[17/]

The auditor should take into account the results of the fraud risk assessment when planning and performing an audit of internal control over financial reporting.[18/] The auditor should evaluate whether the company's controls (including controls over significant unusual transactions, particularly those that result in late or unusual journal entries) sufficiently address the identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls.[19/]

Responding to Risks of Material Misstatement

When the auditor has concluded that there is a significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision.[20/] The auditor's response to the assessment of the risks of material misstatement of the financial statements due to fraud is influenced by the nature and significance of the risks identified as being present and the company's programs and controls that address these identified risks.[21/]

The auditor's response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating

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[15/] AU sec. 316.24-.25.

[16/] AU sec. 316.28.

[17/] AU sec. 316.68.

[18/] Paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[19/] Ibid.

[20/] AU secs. 312.17 and 316.50.

[21/] AU sec. 316.47.

audit evidence.[22] Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud associated with significant unusual transactions.[23]

As part of the overall responses to the risks of material misstatement due to fraud, the auditor should consider management's selection and application of significant accounting principles, including those related to significant unusual transactions.[24] In this respect, the auditor may have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement of the financial statements.[25] The auditor should consider whether their collective application indicates a bias that might create a material misstatement of the financial statements.[26] In examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, the auditor should consider that inappropriate entries or adjustments may be applied to accounts that contain significant unusual transactions.[27] The auditor also should evaluate whether analytical procedures that were performed in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement resulting from significant unusual transactions.[28]

In evaluating whether the business rationale (or the lack thereof) for significant unusual transactions suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets, the auditor should consider:

- Whether the form of such transactions is overly complex;
- Whether management has discussed the nature of and accounting for such transactions with the audit committee or board of directors;

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[22] AU sec. 316.13. In addition, paragraphs .07-.09 of AU sec. 230, *Due Professional Care in the Performance of Work*, notes that due professional care requires the auditor to exercise professional skepticism.

[23] Ibid.

[24] AU sec. 316.50.

[25] Ibid.

[26] Ibid.

[27] AU secs. 316.58 and 61.

[28] AU sec. 316.69.

- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;

- Whether transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or board of directors; and

- Whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the company under audit.[29/]

If the company has entered into a significant unusual transaction and the combined assessed level of inherent and control risk is high, in addition to examining documentation held by the company, the auditor should consider confirming the terms and amounts of the transaction with the other parties.[30/] The auditor also should obtain an understanding of the substance of the transaction to determine the appropriate information to include on the confirmation request.[31/]

The auditor must identify all significant findings or issues (including significant unusual transactions) in an engagement completion document.[32/] The auditor must document actions taken to address significant unusual transactions (including additional evidence obtained), and the basis for the conclusions reached.[33/] In addition, a principal auditor that decides not to make reference to the audit of another auditor, among other things, must obtain, review, and retain an engagement completion document from that auditor.[34/]

Engagement Quality Review

The engagement quality reviewer should review the engagement completion document and confirm with the engagement partner that there are no significant unresolved matters, including unresolved matters related to significant unusual

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29/ AU secs. 316.66-67.

30/ Paragraph .08 of AU sec. 330, *The Confirmation Process*.

31/ AU sec. 330.25.

32/ Paragraphs 12 and 13 of Auditing Standard No. 3, *Audit Documentation*.

33/ Paragraph 12 of Auditing Standard No. 3.

34/ Paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

transactions.[35] The engagement quality reviewer also should, among other things, evaluate whether (1) appropriate consultations have taken place on difficult or contentious matters, and review the documentation, including conclusions, of such consultations and (2) appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.[36]

Consulting Others

A firm's policies and procedures should provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with significant unusual transactions).[37] Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority.[38] The nature of the arrangements for consultation depends on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.[39] In addition, procedures performed by filing reviewers for U.S. Securities and Exchange Commission ("SEC") filings by SEC registrants audited by foreign associated firms of registered firms that were members of the American Institute of Certified Public Accountants' SEC Practice Section should generally include discussing with the engagement partner any significant auditing, accounting, financial reporting, and independence matters that come to the attention of the filing reviewer, including how such matters were addressed and resolved.[40]

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[35] Paragraph 10.e of Auditing Standard No. 7.

[36] Paragraphs 10.h and 10.i of Auditing Standard No. 7.

[37] QC sec. 20.19.

[38] Ibid.

[39] Ibid.

[40] PCAOB Rule 3400T, *Interim Quality Control Standards.*

Evaluating Financial Statement Presentation and Disclosure

The auditor's opinion that the financial statements are presented fairly in conformity with the applicable financial reporting framework should be based on whether:

a. The accounting principles selected and applied have general acceptance;[41/]

b. The accounting principles are appropriate in the circumstances;

c. The financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation;

d. The information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed; and

e. The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.[42/]

The auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles.[43/] Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance.[44/] The auditor should consider whether the substance of transactions or events, including significant unusual transactions, differs materially from their form.[45/]

[41/] The auditor should look to the requirements of the SEC for the company under audit with respect to accounting principles applicable to that company. See Rule 4-01 of Regulation S-X.

[42/] Paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

[43/] AU sec. 411.03.

[44/] AU sec. 411.06.

[45/] Ibid.

The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters.[46/] An auditor considers whether a particular matter should be disclosed by management in light of the circumstances and facts of which he or she is aware at the time.[47/] A basic tenet of the auditing standards of reporting states, "[i]nformative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."[48/] If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should determine the effect on his or her audit report.[49/] The auditor also may emphasize a matter regarding the financial statements in a separate paragraph of the auditor's report.[50/]

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC.[51/] For example, the Management's Discussion and Analysis of Financial Condition and Results of Operations section of annual reports and other filings might include discussions regarding significant unusual transactions.[52/] The auditor should consider whether that information or

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46/ Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

47/ Ibid. When an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to the auditor at the date of the report, and which is of such a nature and from such a source that the auditor would have investigated it had it come to the auditor's attention during the course of the audit, the auditor should take the actions described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

48/ Paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*, and AU sec. 431.01.

49/ AU sec. 431.03.

50/ Paragraph .19 of AU sec. 508, *Reports on Audited Financial Statements*.

51/ Paragraph 18(f) of AU sec. 722, *Interim Financial Information*, and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

52/ For example, Item 303(a)(3)(i) of Regulation S-K instructs management to "[d]escribe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected."

the manner of its presentation is materially inconsistent with the financial statements. If the auditor concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.[53/]

Communicating With Audit Committees

The auditor should determine that the company's audit committee is informed about the methods used to account for significant unusual transactions.[54/] The auditor also should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.[55/] The discussion should be open and frank and generally should include such matters as the clarity and completeness of the company's financial statements, which include related disclosures.[56/] In addition, the discussion should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.[57/] Items that may have such an impact include significant unusual transactions.[58/]

Reviewing Interim Financial Information

The objective of a review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.[59/] The objective of a review differs significantly from that of an audit of annual financial statements and consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting

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53/ AU secs. 550.04-05.

54/ AU sec. 380.07.

55/ AU sec. 380.11.

56/ Ibid.

57/ Ibid.

58/ Ibid.

59/ AU sec. 722.07.

matters.[60/] Certain auditing procedures may be performed concurrently with the review of interim financial information.[61/] For example, there may be significant unusual transactions occurring during the interim period under review for which the auditing procedures needed for purposes of the audit of the annual financial statements could be performed, to the extent practicable, at the time of the interim review.[62/]

During a review of interim financial information, the auditor should make inquiries of members of management who have responsibility for financial and accounting matters.[63/] Specifically, the auditor should inquire about, among other things (a) significant unusual transactions that may have an effect on the interim financial information, and (b) significant unusual transactions occurring or recognized in the last several days of the interim period.[64/] If the auditor becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the auditor should make additional inquiries or perform other procedures that he or she considers appropriate to provide a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information.[65/]

When conducting a review of interim financial information, the auditor also should determine whether significant unusual transactions have been identified.[66/] If such transactions have been identified, the auditor should communicate them to the audit committee, or be satisfied, through discussion with the audit committee, that such matters have been communicated to them by management.[67/]

60/ Ibid.

61/ AU sec. 722.23.

62/ Ibid.

63/ AU sec. 722.18c.

64/ Ibid. AU sec. 722.55 contains examples of situations about which the auditor ordinarily inquires of management during a review of interim financial information.

65/ AU sec. 722.22.

66/ AU secs. 722.33-.34.

67/ Ibid.

Standards-Setting Activities

The PCAOB has a project on its standards-setting agenda to address the auditing standards regarding related parties. In connection with that project, the PCAOB is evaluating its auditing standards regarding the consideration of significant unusual transactions. In addition, the PCAOB also has on its standards-setting agenda projects to address other standards referenced in this practice alert. Updates on these activities are available on the PCAOB's website. Relevant links are provided below:

- Release No. 2009-007, *Proposed 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%20026/2009-12-16_Release_No_2009-007.pdf.

- Release No. 2010-001, *Proposed Auditing Standard Related to Communications With Audit Committees and Related Amendments to Certain PCAOB Auditing Standards*, available at: http://pcaobus.org/Rules/Rulemaking/Docket030/Release_No_2010-001.pdf.

- Release No. 2009-002, *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations*, available at: http://pcaobus.org/Rules/Rulemaking/Pages/Docket028.aspx.

- Standing Advisory Group Meeting briefing paper, *Responsibilities of the Principal Auditor*, available at: http://pcaobus.org/News/Events/Documents/04072010_SAGMeeting/Principal_Auditor_Briefing_Paper.pdf.

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