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Heads Up

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The Alert focuses on risks of misstatement due to fraud in audits of certain emerging-market companies and auditors' responsibilities to perform audit procedures in response to those risks.

PCAOB Issues Staff Audit Practice Alert on Audit Risks in Certain Emerging Markets

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Introduction

On October 3, 2011, the PCAOB issued Staff Audit Practice Alert 8 (the "Alert"),[1] which "focuses on risks of misstatement due to fraud . . . that auditors might encounter in audits of companies with operations in [certain] emerging markets" and auditors' responsibilities to perform audit procedures in response to those risks.

As noted in the Alert, "Emerging markets play an increasingly important role in the global economy given their high economic growth outlook and significant market size. [Footnote omitted] Recent disclosures of possible improprieties in financial reporting by companies based in certain large emerging markets in Asia and observations from the [PCAOB's] oversight activities highlight the need for heightened awareness of risks when performing audits of companies with operations in emerging markets." The Alert gives the example that in "two months in 2011, more than 24 companies with their principal place of business in the People's Republic of China . . . filed Forms 8-K with the SEC reporting auditor resignations, accounting irregularities, or both."

This *Heads Up* summarizes the significant themes in the Alert and discusses the related PCAOB guidance.

Fraud Risks and Auditors' Responsibilities

The Alert provides examples of situations, noted in PCAOB staff observations or SEC filings, that indicate a heightened risk of material misstatement due to fraud, including the following (reprinted from the Alert's executive summary):

- Existence of two separate and different sets of financial books and records;
- Discrepancies between the company's financial books and records and audit evidence obtained with respect to the existence and accuracy of cash balances, accounts receivable, and revenues;
- Auditor difficulties in confirming cash balances, including when requesting to visit the offices of the company's bank, or questions about the authenticity of bank statements provided to the auditor;
- Auditors' follow-up visits to bank offices indicating serious discrepancies between bank confirmations provided to the auditor and the bank's actual records, such as previously undisclosed material borrowings and no record of or significant differences regarding certain transactions;
- Attempts by management to intercept or alter confirmation requests or responses;
- Irregularities in sales contracts, such as a company-specific seal affixed on the sales contract that does not belong to the purported customer named in the contract;

[1] PCAOB Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets.*

- Recognizing revenue from contracts or customers whose existence could not be corroborated;
- Recording sales of products shipped to warehouses or freight forwarders where no customer is identified;
- Undisclosed material facts surrounding acquisition transactions, sales transactions, and off-balance-sheet transactions with related parties;
- Recording of assets for which evidence of control, ownership, or title is either unclear or difficult to corroborate;
- Potential double counting of fixed assets;
- Recording of uncorroborated operating expenses for which the business purpose is unclear;
- Manipulation of the accounting records to mischaracterize or conceal payment of bribes or other improper payments;
- Significant unexplained discrepancies between amounts included in the financial statements in SEC filings and amounts included in financial reports to other regulators, such as local authorities;
- Use of personal-type bank accounts held in the name of corporate officers or employees instead of corporate-type bank accounts for company business; and
- Unusual delays by management in the production of routine documents requested by the auditor.

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In addition, the Alert discusses factors that may affect the risk of misstatement in the financial statements, including the incentives, pressures, and opportunities (i.e., points on the "Fraud Triangle") that may be present in, or unique to, emerging markets.

The Alert reiterates the auditor's responsibilities for (1) identifying and assessing risks of material misstatement in the financial statements due to fraud and (2) performing audit procedures in response to these risks. As noted in the Alert, "The auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks, including certain procedures to address the risk of management override of controls." Specifically, the Alert focuses on audit procedures related to the following:

Confirmations

According to paragraph 8 of PCAOB Auditing Standard 15,[2] "Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources." The Alert discusses the importance of confirmation with third parties that are independent and free of bias in response to fraud risks related to the company's bank accounts or customer accounts receivable. It also reiterates the importance of the auditor's maintaining control over the confirmation process and evaluating the intended recipient of a confirmation to determine whether that party is objective or susceptible to management influence. When there is a heightened risk that a confirmation recipient is susceptible to management influence, the auditor needs to consider whether "other procedures are necessary to obtain sufficient appropriate audit evidence."

Revenue Recognition

PCAOB Auditing Standard 12[3] states that the "auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks." The Alert gives examples of ways in which management in emerging markets might attempt to overstate or "conceal improprieties in recording" revenue. It reiterates requirements for the auditor to "obtain an understanding of the company and its environment," including the composition of revenues and nature of revenue transactions, and to exercise professional skepticism in reviewing documentation obtained as audit evidence as well as to corroborate management explanations.

[2] PCAOB Auditing Standard No. 15, *Audit Evidence*.

[3] PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

Transactions With Related Parties

The Alert discusses factors in emerging markets that may give rise to risks associated with undisclosed related parties or undisclosed related-party transactions. Paragraph 85(A.2) of PCAOB AU Section 316[4] states that "[s]ignificant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm" constitute an example of a fraud risk factor. The Alert indicates that "[t]o obtain sufficient appropriate audit evidence with respect to related party transactions, an auditor should design and perform procedures that take into account the specific environment in which a company operates."

Using the Work of Other Auditors

The Alert directs "auditors' attention to the standards that apply to using the work of other auditors and engaging assistants from outside the firm," including PCAOB AU Section 543[5] and Staff Audit Practice Alert 6.[6] For example, paragraph 2 of PCAOB AU Section 543 points out that when "significant parts of the audit . . . have been performed by other auditors," an auditor is required to determine whether its own participation in the audit is sufficient for it to serve as principal auditor. In addition, PCAOB Auditing Standard 10[7] provides requirements and guidance related to engagement assignments. The Alert discusses engagement assignments in the context of considerations such as risk assessment, language and geographic barriers, and evaluation of the other auditor's professional reputation.

The Alert also describes the auditor's responsibilities for discussing with other auditors matters that affect fraud risks, including considerations related to emerging markets, such as local customs and business practices.

[4] PCAOB AU Section 316, "Consideration of Fraud in a Financial Statement Audit."

[5] PCAOB AU Section 543, "Part of Audit Performed by Other Independent Auditors."

[6] PCAOB Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm.*

[7] PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement.*

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